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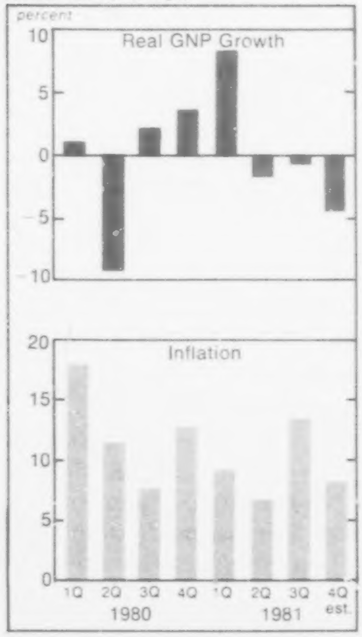
Deep U.S. Decline Unlikely

Until recently, the U.S. economy's decline was slow, erratic, and concentrated in relatively few industries. The weakening, however, is intensifying and now appears more generalized. When industrial production dropped 0.8% in September, almost every major industrial sector—with the important exception of defense production—was down. September also saw a fall of average weekly hours of work in 17 of 20 manufacturing industries. Car sales plunged so dramatically when the late-summer rebate program ended that auto companies had to reinstate them. Housing activity remains depressed, capital goods orders are on a downward trend, and retail sales of non-durables appear to be slackening.

Key U.S. economic indicators
(annual rates of change)



The critical question is whether the current economic weakness will remain relatively mild throughout, or accelerate. This matter may well be settled within the next month or two. The September drop in industrial production and new orders reflects widespread recognition that inventories had become excessive. Beginning steps have thus been taken to correct this condition. If the loss of income associated with production cutbacks leads to further marked reductions in sales, a downward economic spiral could result.

Present indications, however, are that the downward movement will be reasonably restrained. For one thing, the inventory excess does not appear to be either large or widespread. Businesses have been cautious about inventories, owing to the high cost of financing them. And help is on the way on the demand side as well. Interest rates—at least short-term rates—have come down and are expected to fall further. Moreover, federal taxes have been cut, with larger reductions in store for 1982. And further moderation in inflation is likely—the 1982 rate will be about 7%, versus 9% in 1981 and 10% in 1980. All of these influences should support real demand and help restrain the decline in business activity.

Nonetheless, the fourth quarter of 1981 will probably register a drop in real GNP of 4%-5%, at an annual rate. And there may be slight further slippage very early next year. After that, a pick-up is likely, which should accelerate subsequent to the July 1 tax cut. Real GNP could grow by 2% in 1982, fourth quarter to fourth quarter. This would be a welcome change after real growth of well below 1% in 1981 and the fractional decline in 1980.

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Canadian slowdown will not preclude strong economic growth for 1981.

After two quarters of strong growth, business indicators for the third quarter of 1981 point to a slackening of Canada's economy. Housing starts and consumer demand have fallen from their second-quarter highs, exports have declined, and the index of real GDP fell 0.5% in August after a 1.4% decline in July. Although strike activity has contributed to the economic slowdown, reduced aggregate demand has been the major cause. The weaker pace of growth, however, has further eased inflationary pressure—especially in the industrial sector. On balance, Canada's economic weakening will take some steam out of the 4.5% annual growth rate posted for the first half of the year. Nonetheless, real GNP growth of at least 3.5% for 1981 is a strong possibility.

Italy's large current-account gap should narrow in 1982.

Italy recorded a trade deficit of some 14.9 trillion lira in the first nine months of 1981, compared with a deficit of 13.6 trillion lira for the same period last year. While data on this summer's receipts from tourism and other invisibles earnings are not yet available, results to date offer little hope that this year's current-account deficit will be much below last year's $10-billion gap. Nonetheless, the domestic economy is weakening, and the recent realignment of the lira within the European Monetary System has restored most of the competitiveness Italian exports lost over the past year. Both of these factors point to an improvement in the trade balance in volume terms. Stable oil prices in U.S. dollar terms and a somewhat weaker dollar would then leave room for a narrowing in the current-account deficit in 1982. The extent of the deficit decline depends in large measure on the pace of economic recovery elsewhere in Europe, which currently appears likely to remain slow until the second half of next year.

Norway's oil wealth provides leeway for policy maneuvering.

Although successive Norwegian governments have found it difficult to reconcile the fast-growing oil sector with their overall economic strategies, Norway's oil wealth affords it substantial protection against short-term difficulties. Large wage settlements in the oil sector have tended to trigger similarly large settlements in other sectors and to fuel inflation. The current wage agreement permitted a pay rise last spring and allowed for a further autumn adjustment, but oil and gas workers in the Frigg and Ekofisk fields have called illegal strikes to demand an improved system of pay (the Frigg strike has since been settled). Although the strikes are costly, they are hardly a cause for alarm. Norway's trade account for January-September 1981 showed a kr. 10.2 billion surplus, thereby guaranteeing a surplus for the year. Moreover, the recent substantial gas discoveries—at least 100 billion cubic meters proven and with estimates ranging between 200 billion and one trillion meters—from Statoil's first drilling inside the Arctic Circle demonstrate that Norway's energy reserves will last for a century or more.

Australian policy aims to maximize local benefit from resource boom.

In order to increase domestic participation in Australia's resource boom, a broad policy of "Australization" of foreign direct investment is under way. The government recently invited Shell Australia to consider the sale of a 25% interest to local shareholders, and similar advances are expected to be made to other foreign firms. Indeed, the authorities, firmly committed to a long-term Australization policy, seek to promote a 50/50 equity sharing in new resource projects. Other measures taken include the restriction of transfer pricing by multinationals and a 2.5% increase in the sales tax. A direct resources tax has not been imposed, however, nor is one likely in the near future. Nonetheless, the government measures taken so far, combined with efforts by such other sectors as labor to secure a larger role in the resource boom, may affect investment profitability and thus have important implications for foreign investment inflows.

Peru's large public deficit dims economic outlook.

The overriding problem facing the Peruvian authorities is an expanding fiscal deficit. Peru's public-sector deficit reached nearly 6% of GDP last year—up substantially from 1.2% of GDP in 1979—and could widen further to 8%-9% of GDP this year. Spending has grown rapidly on civil servant salaries, defense, interest on debt, and for certain subsidies. Revenues, on the other hand, have risen slowly, reflecting lower tax collections from traditional exports and an income-tax shortfall that may stem from inadequate tax collection and administration. Peru's large fiscal imbalance raises concerns about the country's inflation and external trade prospects. The rate of inflation has slowed in the past few months—latest data indicate an annualized rate of 43%—but the high level of public spending and deficit financing may keep it from abating further. On the external front, a trade deficit of about $300 million is projected for 1981, versus a surplus of $825 million last year. The trade-balance deterioration is due to a sharp rise in imports demanded by the public and private sectors—spurred by an import liberalization policy—and an export shortfall attributable chiefly to weaker metals prices.

Greece's new government hopes to reduce inflation and spur investment.

The substantial electoral victory by Andreas Papandreou's Socialist Party presages a new direction in Greek economic and foreign policy—the details of which are still uncertain. The new prime minister has promised to bring down Greece's rate of inflation, currently running at some 24%, and to spur productive investment through heavier government involvement in investment decisions. On the external front, the new government intends to reexamine Greece's relations with the European Economic Community, which Greece joined at the beginning of this year, and with NATO. Greece's new government will have to grapple with a wide range of underlying economic problems that include a rate of real wage growth that has far exceeded the rate of productivity growth since 1974. This gap has fueled great inflationary pressures (much of which were bottled up through various price controls) and has reduced private-sector investment, particularly in plant and equipment. A growing deficit in the public sector and an unfavorable shift in terms of trade have added to Greece's difficulties.

Bangladesh's budget and external-payments problems prompt credit and import curbs.

The Bangladesh economy is experiencing serious budget and balance-of-payments problems. Because of a shortfall in commodity aid and the poor performance of public-sector enterprises, bank borrowings for deficit financing were heavy in fiscal 1980-81 (ended June 30). As a result, the IMF suspended drawings from its SDR 800-million Extended Fund Facility. To regain the IMF's favor, the government has sought to reduce the rate of domestic credit expansion, cutting the ceiling on bank lending by 5% for the July-September period. But with attention focused on the upcoming presidential election, little action has been taken to prevent a recurrence of the large budget overrun. Externally, Bangladesh's international reserves fell some $120 million in July-September, despite new short-term commercial borrowing. As of early October, reserves stood at just $130 million, sufficient to cover less than three weeks of imports. The government has taken steps to conserve reserves by restricting import licenses, and these measures, together with the restrictions on credit, should help. However, real economic growth may slow as a result.

Petroleum prices a barometer of Algeria's health.

Price patterns for Algeria's hydrocarbon exports have long been a barometer of Algerian economic health, and recent developments further underscore this rule. Because Algeria has traditionally kept its oil prices at the top of the agreed OPEC band, it has been vulnerable to weakening oil market conditions. Its unwillingness to cut contract prices in line with competing producers, such as Nigeria, has caused oil production to fall from 900,000 barrels per day at the beginning of the year to an estimated 600,000 bpd in August. However, Algeria's recent agreement to trim prices by $2 to $38 a barrel in line with the October OPEC accord at Geneva should restore some competitiveness. Meanwhile, disagreements with customers persist over gas export prices. The longstanding dispute with Gaz de France over LNG continues. And the uncertainty over pricing has spread to exports to Italy through the new Trans-Med natural gas pipeline, delaying the commissioning of the service until a compromise is achieved.

The U.S. Economy

The Constraints on Fiscal Policy

President Reagan's recent observation that the U.S. economy has probably slipped into recession has heightened concerns about the size of the budget deficit in fiscal 1982 and beyond. Because the slump will restrict revenues and trigger expanded transfer payments, some private economists are even saying that this year's deficit could approach or exceed $100 billion—a figure that would virtually preclude a balanced budget in fiscal 1984. Mr. Reagan's proposed $13 billion in added spending cuts and $3 billion in higher revenues would have only a small impact. And the passage of even these limited measures is far from certain.

The administration has been somewhat perplexed about recent developments. Earlier this year, it proposed large tax reductions for both businesses and individuals, to be offset almost dollar-for-dollar by cuts in federal spending. Monetary stringency was to reduce actual inflation and inflation expectations, leading to lower interest rates as investors accepted lower inflation premiums. And higher real growth spurred by the tax cuts was to increase revenues sufficiently to move the budget toward balance in fiscal 1984.

The U.S. Congress initially complied with almost every detail of the proposed tax cuts—although it did scale back the individual reduction and delay its introduction. Congress, however, then attached provisions that had the effect of reducing revenues, such as the "all-savers" certificate, and more generous treatment of investment tax credits and depreciation through leasing activity. Officially, these two provisions were estimated to reduce fiscal 1982 revenues by $5 billion, although it now appears that the revenue loss could be far greater.

Congress then approved only $36 billion of spending reductions from the "current service" levels (what spending would have totaled without legislative action); Mr. Reagan had proposed $49 billion. Moreover, the increased gap caused by Congress' revenue-reducing initiatives was not addressed.

Recent developments have lowered short-term interest rates and bond yields somewhat, but continued investor skepticism has kept interest rates higher than expected, driving up estimated interest costs on the public debt by at least $10 billion. Interest rates stuck in the upper teens also continue to batter the construction industry and reduce consumer confidence. With sales worse than expected, businesses piled up inventories. Production cutbacks to correct this overhang now dim the near-term economic outlook. If real economic growth in 1982 turns out to be only 2%, as against the administration forecast of 5%, the estimated deficit could widen by an additional $25-30 billion.

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF				
			6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of il credit, n lions of de
Africa	**Algeria**	Private-sector participation in economic development to be encouraged.	June	— 4%	29.0*	1,525	Aug.	3,586	— 3%	1.3	0
	Angola	South African air attacks and drought aggravate food deficit.	June	— 8%	3.6	500	n. a.	—	—	—	—
	Cameroon	Economy estimated to be growing at 5%-6% real annual rate.	Dec.	— 2%	6.5	790	May	86	— 57%	0.7	6
	Egypt	Twenty new oil exploration agreements will have been signed by yearend.	Mar.	+ 72%	22.7	535	July	726	— 33%	1.3	108
	Ethiopia	Coffee farms to be modernized and expanded.	Feb.	— 25%	4.1	125	Aug.	107	— 17%	1.8	84
	Ghana	Another huge budget deficit and lack of monetary control foreseen for fiscal 1981-82.	June	— 18%	4.6	400	June	148	— 60%	1.5	33
	Libya	Some nonessential projects in 1981-85 development plan may be delayed.	June	— 8%	23.0	8,050	May	13,378	+ 41%	13.5	0
	Mauritius	Losses from 20-year-low 1980 sugar output cause investment cutbacks, aggravating unemployment.	Mar.	— 12%	6.5	675	Aug.	19	+ 41%	0.3	136
	Morocco	Poor weather reduces 1980-81 citrus fruit crop yield by 6%.	June	— 10%	18.1	896	July	127	— 57%	0.3	448
	Nigeria	Investment in new companies to be made easier for local firms with foreign shareholders.	June	— 8%	78.0	1,013	July	7,964	— 13%	8.3	0
	Sierra Leone	Depressed agriculture in north to receive $12 million in external grants and loans.	Feb.	— 39%	0.9	262	Aug.	22	— 30%	0.6	55
	South Africa	Business leaders submit proposals for early implementation of social reforms.	July	— 17%	76.9	2,627	Aug.	920	— 17%	0.5	0
	Tunisia	The 1982-86 development plan provides for construction of 40,000 new homes per year.	Mar.	+ 18%	8.6	1,350	July	528	— 21%	1.8	0
	Zaire	No relief in sight from government's fiscal austerity measures.	Dec.	— 5%	6.8	240	Aug.	104	— 42%	1.4	265
Middle East	**Kuwait**	Several contracts awarded in infrastructure, hydrocarbon development, and small-scale industry.	June	+ 1%	27.3	19,870	Aug.	3,686†	+ 22%	7.3	0
	Qatar	Estimated cost of North West Dome Gas field development project raised 50% to $6 billion.	June	+ 18%	5.0	23,100	Dec.	343†	+ 19%	2.7	0
	Saudi Arabia	Official denies government's intention to build $7-billion oil storage facility on Red Sea.	June	+ 23%	117.6	19,500	Aug.	26,606†	+ 18%	3.4	0
	United Arab Emirates	Government threatens tough penalties for foreign firms that violate labor regulations.	June	+ 9%	16.0*	19,275	Aug.	2,633†	+ 31%	8.6	0

*1979

†Excluding state reserves

Virtually all of the key participants in the budget process acknowledge the likelihood of a larger-than-anticipated deficit. But there is a difference of opinion as to how to address it. Some would scale back or delay the individual income tax cuts; others would cut non-defense spending further; still others would limit the increase in defense spending; and many argue that "revenue enhancements" (i.e., tax increases) will be needed.

All of these measures may have to be utilized to some degree if the federal budget is to be held in the $40-50 billion range in fiscal 1982, thus keeping the goal of budget balance in fiscal 1984 in sight. Delaying the personal income tax reductions in 1982 from July 1 to October 1 would save about $7-8 billion in fiscal 1982. The additional 10% reductions in fiscal-1982 non-defense spending Mr. Reagan has already requested, if passed promptly, could save another $13 billion. In an atmosphere of general austerity, the scheduled increase of nearly 20% in the defense budget could perhaps be trimmed back by stretching out spending and scrutinizing costs more closely.

The list of taxes that could be raised is lengthy. Most likely are higher excise taxes on alcohol and tobacco. Adjusting them for inflation and equalizing tax rates on various forms of alcoholic beverages could raise between $5 and $10 billion. Accelerated decontrol of natural gas coupled with a windfall profits tax could raise at least $10 billion in its first year. A 10% oil import fee, or an increase in the federal excise tax on gasoline to 14¢ a gallon, would raise about $10 billion. And eliminating deductions for interest on non-automotive consumer credit (consistent with the administration's goal of increasing incentives to save) could raise as much as $4 billion.

The long list of policy actions indicates the magnitude of the measures needed to hold the fiscal 1982 deficit in the $40-billion range. Absent from the list, however, are changes in benefit levels for Social Security recipients, other federal pensioners, and other income transfer recipients. Since these programs together with interest on the debt account for nearly 50% of the budget, exempting this area from budget cuts requires that the axe fall even harder elsewhere.

Of course, the impact of cutting spending further or raising taxes when the economy is contracting will not be beneficial in the short run. The deficit may not shrink as much as expected either. To "chase the deficit" by ever larger spending cuts and ever higher taxes carries the risk of worsening or prolonging the economic downturn. Poorer economic performance will in turn make it less likely that Congress will enact all of these or similar deficit-reducing proposals. So will the fact that 1982 is an election year. But if those who are skeptical about the ability of the United States to put its economic house in order are to be satisfied, Congress and the president must enact enough deficit-narrowing measures, perhaps $30 billion, to demonstrate their control over the budget. Their reward would likely be much lower interest rates in 1982, and the prospect of a durable, less inflationary expansion in 1983 and beyond.

Douglas L. Bendt

PAYMENTS		MONEY AND BANKING							COUNTRIES
MF nil- ollars	current influences on payments	12-month changes latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars November 4, 1981	change from year earlier November 4, 1981	current monetary conditions	
	Oil output in Jan.-Aug. period down 16% from year-earlier period.	Dec. '79	+ 12%	Dec.	+ 17%	.2335	−12%	Credit to private sector continues to expand.	**Algeria**
	Oil earnings in 1981 estimated at over $2 billion, owing to higher output.	n. a.	—	—	—	.0325	n. a.	International reserves decline.	**Angola**
	Oil companies beginning work on new offshore deposits.	Dec.	+ 8%	May	+ 11%	.0036	−23%	Supply of credit very tight.	**Cameroon**
	External public debt put at $14 billion at end 1980, up $2 billion from '79.	Feb.	+ 12%	June	+ 6%	1.23	−14%	Foreign reserves in July fell $279 million.	**Egypt**
	Worsening foreign-exchange position brings tighter import license curbs.	June	+ 5%	June	+ 16%	.4925	+ 2%	Use of IMF credit bolsters reserves.	**Ethiopia**
	Weak export receipts spur improved incentives for commodity exporters.	May	+125%	May	+ 35%	.3700	+ 2%	Credit to public sector up sharply.	**Ghana**
	Oil output averaged 1.3 million bpd for Jan.-Aug., down 29% from year ago.	n. a.	—	Dec.'79	+ 33%	3.41	+ 1%	Money expansion slows owing to drop in foreign reserves.	**Libya**
	Rupee devaluation of 20% vs. SDR should boost tourism earnings.	Apr.	+ 15%	July	+ 2%	.1000	−23%	Stringent bank lending restrictions continue.	**Mauritius**
	Wholesale price of phosphate rock holding steady at $49.50/ton.	Mar.	+ 10%	May	+ 9%	.1850	−24%	Reported foreign-exchange reserves fluctuating sharply.	**Morocco**
	Tougher import curbs and slower dividend remittances to save reserves.	Sept.'80	+ 9%	Apr.	+ 29%	1.5375	−21%	Tightening of credit availability likely.	**Nigeria**
	Rising bauxite and rutile exports diversify export base.	Mar.	+ 13%	June	+ 2%	.9925	+ 5%	IMF-imposed tight credit policy continues.	**Sierra Leone**
	Weakening rand headed toward parity with U.S. dollar.	July	+ 15%	[illegible]	+ 40%	1.0440	−22%	Monetary policy to remain tight well into 1982.	**South Africa**
	Trade gap for first half was $756 million, up 35% from first-half 1980.	May	+ 7%	May	+ 23%	2.0650	−18%	World Bank lends $42 million for grain project.	**Tunisia**
	Copper prices and world inventories remain low.	May	+ 22%	May	+ 52%	.1875	−47%	Zaire devalued to 5.5 per U.S. dollar in July.	**Zaire**
	Oil output in Jan.-Aug. averaged 953,000 bpd, down 35% from like period in '80.	Dec.	+ 9%	July	+ 22%	3.5585	− 4%	Money supply expanding steadily.	**Kuwait**
	Jan.-Aug. oil output averaged 432,000 bpd, down 9% from like '80 period.	n. a.	—	Dec.	+ 9%	.2750	0	Credit to private sector expanding steadily	**Qatar**
	Oil output ceiling of 8.5 million bpd reimposed Nov. 1.	Dec.	+ 2%	Jan.	+ 9%	.2930	− 3%	Money supply growth accelerates.	**Saudi Arabia**
	Dubai's aluminum export smelter attained capacity production in September.	n. a.	—	June	+ 14%	.2730	0	Sharjah floats a $55-million Euroloan.	**United Arab Emirates**

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World Interest Rates

market rates of Nov. 4, 1981; bond yields as of Oct. 30, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00 penalty large banks 15.00	18.21	15.50	13.00	9.50	7.50	19.00 penalty rate 22.00	9.00	6.00	6.25
Day-to-Day Money	14.75 Nov. 5	21.00	15.50	15.00	15.625	11.00	20.125	12.75	7.00	7.4375
Treasury Bills 91-day, Middle Rates	12.16 discount basis	17.65	15.00	15.65	n. a.	n. a.	19.49 87-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	14.00 finance paper discount basis	18.10 finance paper 15% tax w/h	13.80	12.90 Certified	15.625 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.70	17.80 15% tax w/h	15.00	12.90 Certified	not traded	9.90	24.35	no market	10.625	no market
Government Bonds Long-term, new and old issues, average yield	14.76	16.00	15.60	10.65 20% tax w/h	16.48	10.32	21.06	12.53	6.01	8.40
Industrial Bonds prime, long-term, new and old issues, average yield	15.55 Aa Industrials	18.00	16.85	19.51	17.64	10.55	20.90	13.53	6.875	7.21
Bank Short-Term Rate to Best Borrowers (prime rate)	17.50	20.00	15.50	18.00	17.35	14.50	22.50 ⅛ quar'ly fee on outstdng.	14.50	11.50	6.75
Bank Time Deposits 3-month	13.875 Cert. of Dep.	18.10	15.625	15.25	15.50	11.35	10.75	12.75 large deposits	9.75 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	15.25	no market	15.9375	no market	16.75	11.25	no market	13.00	10.75	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8361	1.8745	.02681	.1789	.4512	.000844	.4089	.5577	.0044
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.912 *D*	.5975 *D*	3.779 *D*	1.608 *D*	5.231 *P*	6.751 *D*	2.465 *P*	4.279 *P*	7.916 *P*

Eurodollar Deposits

(London, interbank, bid)

November 5

7-day	**14.75**
1-month	**14.75**
3-month	**15.125**
6-month	**15.375**

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	**−2.036**
U.S.-Canada Treasury Bills	**−1.602**
U.S.-Canada Finance Co. Paper	**− .939**
Eurodollars-U.K. Local Auth. Deposits	**+ .349**

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	**16.00**
Over 7 yrs.	**16.00**
DM Bonds	
7 yrs. and under	**10.312**
Over 7 yrs.	**10.187**

Gold Price

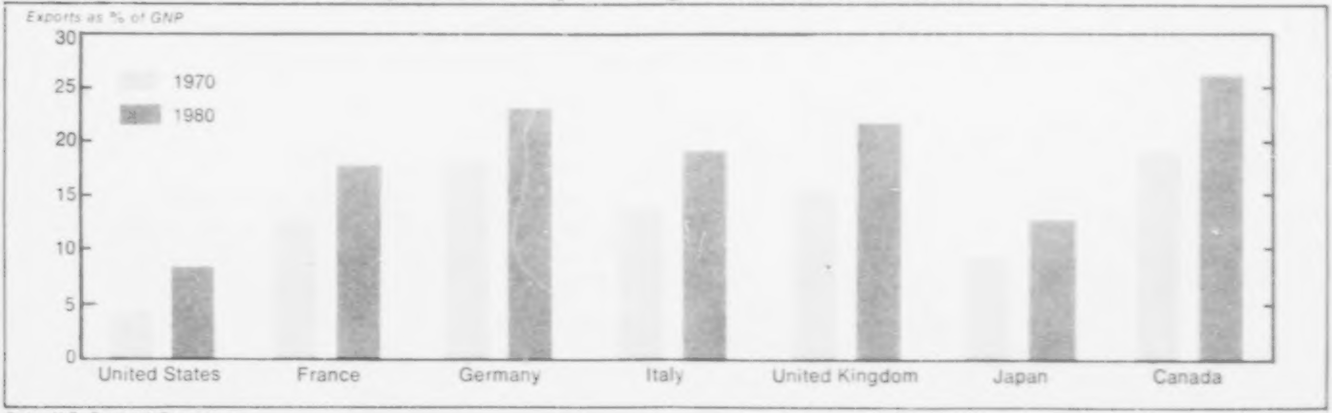
London
afternoon fixing

428.25

(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Export role expanding in industrial nations



Data: U.S. Dept. of Commerce

Appraising the European Monetary System

The European Monetary System (EMS), an outgrowth of the old European Community joint currency float or "snake", will celebrate its third anniversary this spring. It was formed in the wake of extreme U.S. dollar weakness in 1977-78 to insulate Europe's financial and trade flows from deviations in U.S. economic policies, particularly as they were transmitted to Europe via dollar depreciation and the inflationary bent of U.S. policy. The desired method of insulation was a unified response that would both underscore and promote European policy harmony.

Now that the EMS has experienced several parity adjustments, an appraisal of its effectiveness seems useful. Any such evaluation should focus on whether 1) intra-European bilateral exchange rates have become more stable; 2) inflationary pressures in Europe have been reduced; and 3) policy harmonization in Europe has advanced. Judged on the basis of these three criteria, the EMS has fallen short of its objectives, succeeding in only one area—stabilizing intra-European bilateral exchange rates. On all other counts, the EMS's success has been less than expected. Indeed, its failings in these other areas may ultimately lead to its demise.

Exchange-rate variance reduced

Almost by definition, a fixed-exchange-rate system assists in reducing bilateral exchange-rate movements between member currencies. In the case of the EMS, deviations from stable parities are the result of two factors: the allowable exchange-rate deviations permitted by the EMS, and official parity adjustments.

The EMS allows bilateral rates to deviate by 2.25% against central parities for all currencies except the Italian lira, which is allowed a 6% deviation band. This amount of bilateral exchange-rate deviation represents an effective reduction in exchange-rate variance between the currencies of the former "snake" members and France and Italy, as compared with the experience of the pre-EMS era. The EMS also enhances the stability of European bilateral exchange rates through the increased substitutability of all EMS currencies for the German mark—despite the mark's worldwide role as an alternative reserve currency. This has tended to ease pressures for changes in bilateral exchange rates, although not entirely.

With regard to official parity changes, there have been two major EMS realignments to date. The first, in the fall of 1979, involved only modest parity modification. The second, in the fall of 1981, instituted an 8.5% change between the values of the German mark and both the French franc and the Italian lira.

Still, even with all the official parity changes and permissable deviations, day-to-day bilateral exchange-rate variations under the EMS have improved. Exchange rate changes from March 13, 1979 through October 31, 1981 have not been large enough to disrupt European financial or trade flows. Among the EMS members, the largest percentage exchange-rate change during this period was for the mark/lira and mark/franc, and these changes were small given the 20 percentage-point change in the mark/dollar rate that occurred in the same period with a far greater degree of variance.

Official parity changes have been required under the EMS, however. An analysis of the causes of such parity changes—traceable to inflationary pressures and policy actions—is key to understanding the turbulence that underlies the apparent stability within the EMS.

Little impact on inflation front

When the EMS was founded, the two chief additions to the snake arrangement, Italy and France, had inflation rates that differed significantly from such former snake members as Germany (see below). Theory states that in a fixed-exchange-rate system (that is perceived as remaining fixed), where trade and capital-flow barriers are nonexistent, comparable inflation measures will tend toward equality among member countries. The evidence, however, shows that inflation rates have not made much progress toward equality.

Pre- and Post-EMS Inflation Rates

(year-over-year % change in CPI)

Country	March 1979	September 1981
Germany	3.1	6.5
France	10.1	13.9
Italy	13.1	18.3

The reasons for the poor showing on the inflation front are mainly two. First, because the EMS allows for official parity adjustments, the markets do not believe that today's exchange rates will exist well into the future. Hence, business decisions, both financing and pricing policies, reflect the expectation of potential exchange-rate adjustments and varying national policies. Second, there are capital-flow barriers within Europe, particularly with regard to France and Italy, making cross-country arbitrage costly and allowing inflation rates to remain apart or to diverge.

In sum, the establishment of the EMS did little to eliminate the divergence in inflation performances within Europe since it did not allow a textbook fixed-rate system to operate. A true fixed-rate system would have provided the discipline to guarantee effective policy harmony. The failure of inflation rates (and also interest rates) to become more consistent across

Appraising the European Monetary System

(continued from page 7)

member countries thus also signals the EMS's inability to promote European policy harmony.

Policy harmony not enhanced

The EMS was conceived at a time when intra-European policy differences were overshadowed by differences with the United States. Nonetheless, harmonization in Europe with respect to inflation policies has not existed in the 1970s. Evidence of this is provided by the differences in interest rates that have long persisted among the European currencies. If the EMS countries had made a firm commitment to policy harmony and a fixed-exchange-rate system, interest-rate differentials would have narrowed considerably.

For the EMS to continue to provide stability of bilateral exchange rates within Europe, the need for official parity changes must be reduced. But recent policy shifts indicate that they may increase. Since the first official EMS parity change in October 1979, the United States switched from a relatively inflationary policy stance to an anti-inflationary, tight-money policy. This tended to obscure intra-EMS policy differences, because the exchange-rate consequences of the U.S. policy switch led to a resurgence in the dollar as a reserve currency vehicle. This resurgence came partly at the expense of the German mark. With some of the international pressure off the mark, the EMS enjoyed a period of relative stability.

This relative stability was also characterized by a modest shift in Germany toward policies more consistent with those in France and Italy—evidenced by rising interest rates in Germany. Although this may have been falsely perceived as an indication of German policy tightening, in fact it reflected the markets' moving to equalize interest rates within the EMS as the threat of a German move to a severe anti-inflationary stance lessened. Thus, there was some shift toward policy harmony by Germany in 1980, but it was in the nature of accepting the higher inflation rates of its partners. And indeed, Germany's inflation rate has been rising since the formation of the EMS.

But although Germany's inflation rate is rising, it still is less than double-digit, indicating that the movement toward policy harmony has been small. In fact, that movement begun last year has been overshadowed by events in 1981. Italy failed to adopt policy changes to put itself on a lower inflation path. Thus, even with 6% exchange-rate deviation bands allowed from the official EMS parities and the existence of numerous capital-flow barriers, the pressures for lira depreciation have been building all year. France, after its socialist victory, moved to reverse its previous policies of market deregulation and to act quickly to stimulate its economy, virtually guaranteeing higher inflation. These policy shifts stood in sharp contrast to Germany's growing concern for its rising inflation rate. In view of such large policy differences, the official parity change of the fall of 1981—an 8.5% devaluation of the French franc and Italian lira against the German mark—may be only the first of more to come.

Summing up, the EMS is now at a crossroads. Its success in eliminating much of the bilateral exchange-rate variance within Europe has not been accompanied by moves toward policy harmony and more consistent inflation patterns. The financial markets view this as a problem that is not going away, but getting worse—as evidenced by the continuation of substantial interest-rate differentials. If the EMS is to survive, particularly in a world in which the U.S. dollar's role as an international reserve currency is secure, inflation policies must move in a much more consistent pattern. For Europe to accomplish this will require major compromises among governments, which at this point appear unlikely.

Bluford H. Putnam

Quarterly Euromarket Report

($ billion, end of period)

Total Market Size	IIQ/80	IIIQ/80	IVQ/80	IQ/81	1979	1980	1981
Gross Size (Claims)	1,206.1	1,248.1	1,321.9	1,346.6	1,110.0	1,321.9	1,550.0
Net Size (Claims)	745.0	775.0	810.0	820.0	665.0	810.0	950.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	280.9	282.0	285.8	289.5	269.5	285.8	335.0
Liabilities to Private Nonbank Foreigners	69.8	72.1	74.7	80.2	65.9	74.7	86.0
Total Claims on Foreigners	347.3	365.0	382.5	390.6	324.0	382.5	440.0
Claims on Foreign Public Borrowers	41.5	46.1	48.8	49.8	42.0	48.8	54.0
Claims on Foreign Private Nonbank Borrowers	129.4	133.1	138.8	142.2	117.7	138.8	165.0

Note: Gross and net Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.

Source: Chase Manhattan Bank estimates based on BIS and national data sources.

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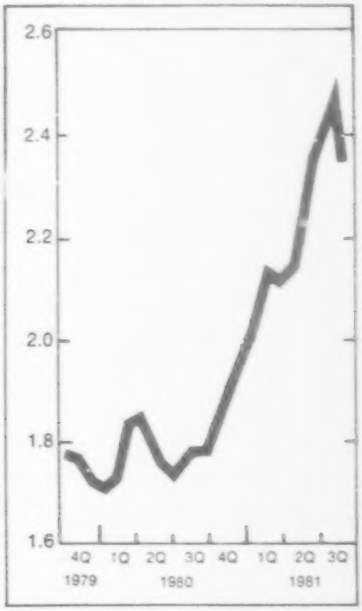
The U.S. Dollar Outlook

The recent decline of the dollar on foreign-exchange markets has raised concerns about the emergence of a period of pronounced and sustained dollar weakness. Some observers have argued that "fundamental" economic influences will dominate throughout 1982 and place continued downward pressure on the dollar. In support of their predictions of dollar weakness, these analysts most frequently cite the anticipated swings in the current-account balances of both the United States and Germany—with the expectation of a worsening in the U.S. balance coinciding with an upturn in the German current account.

DM/dollar exchange rate
(monthly averages)



A major problem with this prevalent view—that future current-account imbalances will lead to sustained dollar weakness—is that it neglects entirely the role of foreign-exchange market expectations. Indeed, it implicitly assumes that market participants are "myopic", that is, unable to take into account the impact of such future events as current-account imbalances until they actually occur. In practice, however, just the opposite is true. Such anticipated developments as future current-account imbalances are quickly discounted by the foreign-exchange markets and are immediately reflected in the spot and forward markets. Thus, since a market consensus already foresees an improvement in the German current account next year and a worsening in that of the United States, these developments should have little further effect on the dollar when they actually occur—unless the market's expectations are far off target.

Putting aside the current-account argument for a major decline of the dollar, market expectations of the major influences on the demand and supply of dollars—future inflation and real growth differentials—do not presage major dollar weakness. Although the dollar may decline in the near term, especially if the United States experiences a much sharper recession than expected, realized inflation differentials favoring the United States should place a limit on dollar weakness. Indeed, if the U.S. economy performs with unexpected buoyancy in 1982, excess demand for dollars may develop on foreign-exchange markets that may very well lead to substantial dollar strength, despite an even weaker U.S. current account.

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Bearish German growth forecasts may prove pessimistic.

German economic growth forecasts for 1982 have been revised downward. The government's official forecast for real GNP growth has been trimmed to 1%-2%, and the latest joint report by Germany's five research institutes forecasts real growth of only 1%, with one institute actually forecasting a decline in real GNP. The forces underlying this downward revision include weaker than previously expected growth in world trade, a restrictive 1982 budget, and the high level of real interest rates—seen for both Germany and abroad. While evidence does point to a delay in Germany's economic recovery, the more pessimistic forecasts may well underestimate the favorable impact of a stronger DM on Germany's inflation rate, and the resulting boost to real incomes and consumer demand in the latter part of 1982.

Restrictive Irish budget expected to halt economy's deterioration.

Despite the narrow majority enjoyed by Ireland's coalition government, a tough budget was introduced this past July to halt the steady widening in the balance of payments and in the budget deficit. The budget increases taxes sharply, and raises prices charged for public-sector services. The restrictive budget will check economic growth in 1982 and is likely to produce a peak inflation rate of about 22%. It is, however, expected to improve the government's finances and the current-account balance, thereby reversing the steady deterioration in the Irish economy that has occurred since 1979. In the longer run, Ireland faces stubborn problems. The service charges on its overseas debt—some £250 million (2.5% of GDP)—will nearly double next year, further straining the balance of payments. And wage settlements, although running below the inflation rate, will raise the growth rate of unit labor costs well above those of many of Ireland's EEC partners. Consequently, several more restrictive budgets are anticipated before the path is cleared for a more sustained economic expansion.

Portuguese economy on retrenchment course.

After a strong performance in 1980, the Portuguese economy is now mired in difficulty. The expansionary policies of last year, the impact of world recession, and a severe drought have pushed the balance of payments into a deficit that is officially forecast to reach $1.7 billion in 1981. GDP growth, which reached 5.5% in 1980, is unlikely to reach even 3% this year, particularly with exports depressed in the face of weak European demand. Inflation, which had receded to 16.6% in 1980, is now climbing steadily again; it reached 23.6% in September, year on year. In response to this scenario, the new government has designed a deflationary budget aimed at cutting the ever-widening public-sector deficit. While reluctant to raise income taxes, the budget calls for higher purchase taxes on luxury items, a freeze on civil service hiring, and reduced deficits in state-owned industries.

Japan's domestic economic slump helps boost its external position.

Although Japanese domestic demand is recovering slowly, it remains weak. Plant and equipment investment by large firms is vigorous, but investment by small firms is sluggish. Public works spending, concentrated in the first part of the fiscal year, is no longer providing as much stimulus to growth. Housing remains depressed, with housing starts in September down for the sixth consecutive month to only 91,800, down 5.6% from a year earlier. Real income and consumer spending have been sluggish, despite a sharp slowdown in inflation, because of a reduction in overtime and bonus payments. In August, average real expenditure by all Japanese households fell 1.3% from a year earlier, the third consecutive monthly decline. In September, however, consumer spending showed some signs of recovery, with retail sales up 9.4% and new car sales up 12.3% from a year ago. As the anticipated pickup in consumer spending spurs industrial production, imports may accelerate. Meanwhile, Japan's external accounts have benefited from the slow recovery of the domestic economy and the weakness of the yen against the dollar, and a current-account surplus of some $7 billion is projected for 1981.

Shortfall in Mexican oil earnings triggers austerity measures.

Various indicators of the Mexican economy are clearly pointing to a growth slowdown this year. The twelve-month moving average for industrial production fell to 8.3% this past June from 9.6% in June 1980. The similar manufacturing average has dropped to 5.4% from 8% over the same period. These slowdowns are the result of the government's response to the unexpected interruption of oil exports this past summer. The shortfall cut $4 billion from anticipated oil export receipts in 1981, prompting a $4-billion reduction in spending and a shift toward monetary restraint. Such restrictions, however, are expected to help reduce the rate of inflation, which has accelerated to 28% because of strong demand pressures. On balance, real GDP growth of about 6.5% is projected for 1981, below last year's 7.4%, but still impressive by world standards.

Colombian current account swings into deficit.

The decline in world coffee prices and higher interest payments on debt have been major contributors to Colombia's growing current-account deficit. The current-account gap of $715 million recorded for the first nine months of 1981 is in sharp contrast to the $543-million surplus for the year-earlier period. The swing into deficit, however, was not unexpected. Coffee prices have been falling during most of the past year, owing to excess supply. And non-coffee export earnings have dropped by 2%, partly the result of lower gold prices and export manufacturing sluggishness. At the same time, Colombian merchandise imports have increased by about 17% because of programmed investment spending economy-wide. The resulting current-account deficit has been financed easily, however. And although international reserves have dipped slightly, they are still a strong $5.2 billion, sufficient to cover 16 months of imports.

New Zealand's export dependence dictates recent policy decisions.

The recent dramatic slowdown in New Zealand's agricultural exports—on which the country is highly dependent—is an important contributor to the country's domestic economic stagnancy and its widening current-account deficit. The government has responded to the problem in several ways. It has purchased $156 million of surplus butter from the United States to prevent the further decline of world prices for butter (a key export); and it has decided to finance a high-risk $1-billion synthetic fuels project, to spur energy and mining development and promote export diversification. The authorities have conceded to the signing of the General Agreement on Tariffs and Trade (GATT) export subsidy code, which commits them to phase out gradually the country's export subsidy. Nonetheless, the government is expected to develop alternative measures of export promotion.

Surge in oil export earnings and new finds for Tunisia.

The increase in oil output and sharply higher prices since 1979 have made petroleum Tunisia's chief foreign-exchange earner. Production of the country's relatively high-quality crude has remained constant at an average 115,000 barrels per day over the last three years, but the 1979 surge in prices helped produce gross oil revenues of $1.1 billion in 1980, equivalent to 51% of total exports. In view of the marked depreciation of the Tunisian dinar relative to U.S. dollar this year, a similar windfall is projected for 1981. At the same time, however, domestic oil consumption has been rising rapidly—at at average annual rate of 12%. Greater local needs have been met through imports of both crude oil and refined products, the values of which have also risen sharply; such imports currently absorb nearly 55% of gross oil export revenues. Tunisia had been expected to become a net oil importer by the mid-1980s, owing to the levelling off of oil output from existing fields and the rapid growth of domestic consumption. However, the recent uncovering of two major deposits will keep it a net oil exporter beyond the 1980s. Although testing has not been completed, the first find (in the Chott Jerid dry lake area) is expected to yield at least 50,000 bpd by 1983. Further brightening the energy—and, thus, balance-of-payments—outlook are the recent discoveries of large amounts of natural gas.

Farmers in Financial Straits

Thanks to good weather and an expansion in acreage farmed, U.S. farm production in 1981 has bounced back to record levels from 1980's drought-reduced harvest. This is good news for American consumers. But for many of the nation's farmers, it signals continued financial difficulty, both this year and next.

Abundant supplies in the face of weak demand, both at home and abroad, have maintained downward pressure on commodity prices—now about 6% below year-ago levels. There has been some easing in farm input cost rises, as prices of fuel and energy-related products have stabilized. But the added costs of persistently high interest rates on expanding farm debt have more than offset the slowdown in input prices. And for the second year in a row, production expenses are expected to outpace cash receipts from the sale of crops and livestock. The U.S. Department of Agriculture projects that net farm income in 1981, even after adjustment for inventories, will be only modestly higher than last year's $19.9 billion and well below the recent peak of $32.7 billion in 1979.

Traditionally, farmers have coped with short-term fluctuations in income by borrowing against farm equity to cover production loans. But such borrowing has become more difficult because of a slowing in the rate of increase in farm land values, as well as high interest rates and expectations that low commodity prices will continue into 1982. Some of the more highly leveraged farmers have been caught in a cash-flow squeeze. And there are indications that delinquencies and defaults in the farm sector may be on the rise.

Of course, not all farmers are affected to the same degree by illiquidity and low levels of net income. The financial health of individual farms varies widely, and aggregate statistics are often misleading. Nevertheless, 1981 has indeed proved to be hard year for some farmers—particularly new entrants to farming and farmers who have recently made large purchases of capital equipment at high interest rates.

At present, the outlook for 1982 is not much better. Given the prospect of lackluster recoveries in the United States and abroad, little growth in demand for American agricultural products is likely. And with this year's bumper harvest, farm prices are expected to remain low, with increases in cash receipts limited. At best, only moderate improvement in production costs can be expected as interest expense for farmers will continue to rise for some time. Thus, farmers may well be faced with a third consecutive year of cash-flow problems. As always, a number of variables—including the size of the prospective Southern Hemisphere harvests, changes in trade and agricultural policy, the value of the dollar, and the weather—could alter the picture substantially.

Europe, Canada & U.S.

Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1980		BALANCE O				
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use c credi lions of
Austria	Proposed 1982 budget is mildly restrictive; 1982 real growth of 2% assumed.	Mar.	+ 1%	75.8	+3.6%	Sept.	4,352	− 8%	2.5	
Belgium	New coalition sought after inconclusive general election; 1982 growth prospects poor.	Aug.	−10%	118.7	+2.0%	Sept.	5,167	−37%	1.0	
Britain	Trough of recession reached, but few signs of sustained recovery evident.	Sept.	− 2%	519.6	−1.4%	Sept.	15,294	−29%	1.7	4
Denmark	Economic output remains depressed, but new orders are rising quickly.	June	+10%	64.7	+0.2%	Sept.	2,453	−23%	1.6	
Finland	Exports continue to bolster economy, but their rate of growth is slowing.	July	− 3%	51.0	+6.0%	Sept.	1,510	−22%	1.3	
France	Pick-up in consumer spending leads economic recovery.	Aug.	− 6%	651.1	+1.2%	Sept.	21,869	−21%	2.3	
Germany	Economy slowed in second and third quarters; official 1982 real growth forecast revised down to 1.5%.	Sept.	− 2%	822.2	+1.8%	Sept.	47,154	− 4%	3.5	
Greece	Socialist party gains absolute majority in parliamentary elections; new policies not yet detailed.	Dec.	+ 3%	38.2	+1.6%	Sept.	1,476	+24%	2.1	
Ireland	Economic activity slowing further in wake of July's restrictive budget.	May	− 2%	17.1	+2.1%	Sept.	1,966	−24%	2.2	
Italy	Domestic economy remains weak; Parliament votes income-tax reductions.	Sept.	+ 1%	394.9	+4.0%	Aug.	19,057	−12%	2.5	
Netherlands	Post-election coalition re-formed after initial failure to agree on 1982 budget.	Sept.	+ 1%	159.9	+1.0%	Sept.	8,443	−26%	1.5	
Norway	Real GDP expected to expand by only 0.5% this year and by 1% in 1982.	Aug.	− 9%	55.4	+3.6%	Sept.	5,463	+ 8%	4.5	
Portugal	Deflationary 1982 budget announced.	Mar.	− 2%	24.1	+3.9%	Aug.	869	− 1%	1.1	
Spain	No indications as yet of any economic upturn.	Dec.	− 5%	208.5	+0.5%	Aug.	11,018	−16%	4.1	1
Sweden	Devaluation and tax cuts should bolster domestic activity.	July	− 8%	124.3	+2.3%	Sept.	4,049	+13%	1.8	
Switzerland	Business slowdown now evident and likely to continue past yearend.	June	0	100.5	+2.4%	Sept.	10,829	−24%	4.4	
Canada	Energy revenues expected to cut proposed 1982-83 fiscal deficit.	July	+ 5%	246.5	+0.1%	Sept.	2,166	−27%	0.4	
United States	Signs emerge of a more widespread and intense economic downturn.	Oct.	+ 2%	2,626.1	−0.2%	Sept.	18,563	+57%	0.8	

New Corporate Bond Offerings Rising

The long-awaited bond rally finally seems to have arrived. Since late October, the yield on 30-year Treasury bonds has fallen by 200 basis points, which translates into a price increase of over 15%. The rally has been triggered not only by declining short-term interest rates, but by economic data indicating that the U.S. economy is clearly in a recession, and that it will be a number of months at best before a recovery in total spending begins.

Perhaps the most significant aspect of the rally is that institutional and retail demand for bonds has strengthened considerably. This is especially impressive in light of the heavy supply of Treasury issues and the potentially huge supply of new corporate bond issues coming to market in the near term.

The response of potential issuers to the shift in the demand for bonds and the resultant improved market conditions will be watched closely by bond-market investors in coming weeks. Already, the decline in long rates has induced a host of corporations to raise funds in the long-term market. Moreover, the potential exists for a further surge in new bond issues. Over the last few years, corporate liquidity has deteriorated significantly and corporate reliance on short-term debt has risen substantially, as many corporations postponed long-term issues in the expectation that market conditions would improve. For example, the ratio of short-term debt to total debt outstanding of manufacturing firms has risen from about 15% in 1977 to close to 25%. Over the same period, the ratio of these firms' liquid assets to current liabilities fell from 28% to 19%.

Whether the developing surge in corporate bond offerings will eventually dominate increased investor demand for bonds—thus reversing the improvement in bond prices—is uncertain. First, it is difficult to gauge the extent to which investor sentiment toward bond investment has or is likely to change. Moreover, if the recent rally reflects a general decline in inflation expectations, some corporations may be reluctant to lock in "high" borrowing costs for the long haul—the converse of bond investors wishing to lock in "high" rates of return.

Yet it seems clear that there is a need for extensive restructuring of corporate debt before the recovery is well under way. In resolving this conflict, many corporations may seek to curtail long-term "lock-in" exposure by concentrating more on medium-term bonds—issues with maturities between 5 and 10 years, rather than 20 or 30 years.

At present, however, it appears that a sizable volume of new bond issues is already reflected in market prices, and thus can be accommodated without material price retreat. It is nonetheless quite possible that the actual volume of new issues may prove even greater than expectations. And such an occurrence could at least temporarily halt the cyclical bond recovery now in progress.

OF PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				central bank rate	exchange rate in U.S. dollars		
of IMF t, mil- f dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	November 18, 1981		current monetary conditions	
0	Current-account gap narrows owing to gains in international competitiveness.	Sept.	+ 7%	Aug.	— 1%	6.75%	.0640	Lower German rates provide more room for maneuvering.	**Austria**
0	Trade and current-account deficits continue to widen.	Oct.	+ 8%	June	+ 7%	13.00%	.0267	Franc to remain under pressure, holding rates up.	**Belgium**
29	Payments balance has worsened since January, but remains in surplus.	Oct.	+12%	Aug.	+10%	14.625%	1.9245	Rates raised to support pound, but downward pressure builds.	**Britain**
0	Current account remains in deficit.	Aug.	+12%	June	+15%	11.00%	.1396	Rates stay high, but net foreign exchange reserves decline.	**Denmark**
71	Jan.-Sept. trade deficit was fmk. 7.2 million, vs. fmk. 5.2 million year earlier.	Sept.	+11%	May	+ 8%	9.25%	.2309	Monetary conditions remain restrictive.	**Finland**
0	Estimated current-account gap of $6.5 bn. in 1981 could top $10 bn. in 1982.	Sept.	+14%	June	+12%	9.50%	.1777	Franc stability in EMS prompts lower domestic interest rates.	**France**
0	Current account set to improve markedly.	Oct.	+ 7%	Aug.	+ 1%	7.50%	.4478	Lombard rate reduced one point in wake of stronger DM.	**Germany**
24	New government to reexamine Greece's role in EEC.	Aug.	+33%	Feb.	— 1%	26.00%	.0185	Supply of credit remains tight.	**Greece**
0	Jan.-Sept. trade deficit totaled £1.4 billion, versus £1.0 billion year ago.	Aug.	+20%	Aug.	— 8%	16.50%	1.5840	Interest rates ease slightly but remain high.	**Ireland**
0	Jan.-Sept. trade gap was 14.9 trillion lira, vs. lit. 13.6-trillion gap year earlier.	Oct.	+19%	June	+11%	19.00%	.00084	Supply of money remains tight.	**Italy**
0	Current account expected to be in surplus this year and next.	Oct.	+ 7%	July	+ 1%	9.00%	.4070	Rates ease in wake of lower German rates.	**Netherlands**
0	Large current-account surplus seen for 1981, thanks to oil.	Sept.	+13%	June	+15%	9.00%	.1727	No easing of monetary conditions seen.	**Norway**
63	Sustained export demand weakness hurting trade balance.	Aug.	+22%	June	+24%	18.00%	.0165	Monetary growth still very rapid.	**Portugal**
93	Jan.-Aug. current-account deficit totaled $4 billion.	Aug.	+14%	June	+10%	8.00%	.01055	Money markets highly liquid.	**Spain**
0	Jan.-Sept. trade deficit was kr. 0.4 billion, vs. kr. 9.8 billion in year-ago period.	Sept.	+11%	n. a.	—	11.00%	.1828	Strong krona allows discount rate cut.	**Sweden**
0	Current-account surplus of 2 billion Swiss francs expected this year.	Oct.	+ 7%	July	— 3%	6.00%	.5618	Tight money policy boosts interest and exchange rates.	**Switzerland**
0	Canadianization being limited to energy industry.	Oct.	+13%	Aug.	— 4%	16.13%	.8464	Interest rates decline generally.	**Canada**
0	Recession could delay current-account weakening.	Sept.	+11%	Oct.	+ 4%	13.00%	—	Interest rates fall as economy weakens.	**United States**

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World Interest Rates

market rates of Nov. 18, 1981; bond yields as of Nov. 13, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00	16.13	14.625 intervention rate	13.00	9.50	7.50	19.00 penalty rate 22.00	9.00	6.00	6.25
Day-to-Day Money	13.00 Nov. 19	20.50	15.75	12.35	15.625	10.80	20.25	11.50	5.50	7.375
Treasury Bills 91-day, Middle Rates	10.05 discount basis	15.35	14.00	15.00	n. a.	n. a.	19.297 59-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	11.50 finance paper discount basis	16.15 finance paper 15% tax w/h	13.23	12.90 Certified	15.50 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	11.40	16.00 15% tax w/h	14.00	12.90 Certified	not traded	9.90	24.20	no market	9.50	no market
Government Bonds Long-term, new and old issues, average yield	13.51	15.05	14.98	10.035 20% tax w/h	16.30	10.02	21.48	11.86	5.73	8.061
Industrial Bonds prime, long-term, new and old issues, average yield	14.20 Aa industrials	16.00	16.47	20.242	17.65	10.10	21.18	13.14	6.725	7.18
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	18.00	16.00	18.00	17.35	14.00	22.50 ⅛ quar'ly fee on outstdng.	14.00	11.50	6.75
Bank Time Deposits 3-month	11.375 Cert. of Dep.	12.75	13.75	14.50	15.50	10.55	10.75	11.25 large deposits	8.75 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	12.9375	no market	14.9375	no market	16.75	10.56	no market	11.375	9.50	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8474	1.9250	.02674	.1778	.4479	.00084	.4088	.5618	.0045
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	3.22 *D*	1.85 *D*	4.81 *D*	3.63 *D*	2.51 *P*	8.75 *D*	1.766 *P*	3.37 *P*	5.40 *P*

Eurodollar Deposits

(London, interbank, bid)
November 19

7-day	12.4375
1-month	12.4375
3-month	12.0625
6-month	12.8125

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.908
U.S.-Canada Treasury Bills	−1.327
U.S.-Canada Finance Co. Paper	−1.208
Eurodollars-U.K. Local Auth. Deposits	+ .1625

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	14.25
Over 7 yrs.	14.50
DM Bonds	
7 yrs. and under	9.9375
Over 7 yrs.	10.125

Gold Price

London
afternoon fixing

403.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	11.0 (Sept.)	12.7 (Oct.)	11.7 (Oct.)	13.9 (Sept.)	6.7 (Oct.)	18.5 (Oct.)	7.3 (Oct.)	3.9 (Sept.)
Industrial production*	2.0 (Oct.)	4.6 (July)	−1.9 (Sept.)	−5.9 (Aug.)	−1.9 (Sept.)	0.9 (Sept.)	0 (June)	3.8 (Sept.)
Trade balance† *(billions of local currency units)*	−$2.58 (Sept.)	C$0.06 (Sept.)	£0.01 (Sept.)	−FF8.46 (Sept.)	DM3.49 (Sept.)	−Lit.2,150 (Sept.)	−SF0.44 (Oct.)	¥748 (Sept.)
Money supply (M1)*	4.2 (Oct.)	4.0 (Aug.)	10.2 (Aug.)	11.6 (June)	1.4 (Aug.)	11.2 (June)	−2.5 (July)	3.0 (Aug.)
Velocity of money (M1)*	12.9 (Mar.)	7.2 (June)	9.8 (Dec.)	n. a.	1.3 (June)	5.1 (June)	n. a.	2.7 (June)
Reserves minus gold *($ million, change from previous month)*	450 (Sept.)	−300 (Sept.)	−516 (Sept.)	−1,670 (Sept.)	1 216 (Sept.)	384 (Sept.)	812 (Sept.)	342 (Sept.)

* Percent change from 12 months earlier

† Figures are only for the month indicated

A Break in the Export Credits Stalemate

The October meeting of the 22-member-nation OECD Export Credits Group achieved an important reduction in government subsidization of export credits. Failing to agree last spring to a virtual elimination of subsidies—by linking minimum allowable export credit rates specified in an international accord to market measures—the United States and its Canadian, European, and Japanese trading partners agreed to sizable increases in interest-rate minimums on government-backed export credits. The U.S. delegates, while reasonably satisfied with the upward adjustment, had sought higher rate increases. They regard the latest consensus as only an interim measure toward the ultimate goal of eliminating export credit subsidization altogether.

The agreement to boost minimum allowable rates by 2¼ to 2½ percentage points for officially supported export credits with maturities over two years (effective November 16) will have broad benefits. It will ease the fiscal burden of export subsidies in Europe somewhat. It will also mean that the United States, unable to provide the large rate subsidies it provided during the Carter administration because of profitability problems at the U.S. Export-Import Bank and retrenchment under the Reagan administration, will lose less ground in the export credits race than otherwise.

The increases in minimum permissable export credit rates mark the first major amendment of the 3½-year-old "Arrangement on Guidelines for Officially Supported Export Credits." The Arrangement spells out minimum interest rates for medium- and long-term export credits that entail some element of government financing; it also limits maturities on long-term credits. The guidelines are as follows:

	2-5 years	Over 5 years	Maximum repayment term
	(percent per annum)		(years)
Rich countries (GNP per capita over $3,000)	11.00	11.25	8½
Intermediate countries (GNP per capita $1,000-$3,000)	10.50	11.00	8½
Poor countries (GNP per capita less than $1,000)	10.00	10.00	10

Although the Paris accord fell short of U.S. and Canadian desires to link Arrangement rates with a proxy for world financial market movements, it represents an important accommodation to longstanding U.S. and Canadian demands for substantial minimum-rate increases. The U.S. Treasury estimates that the boost in rate minimums will reduce export finance subsidies by the industrialized nations by between 20% and 25%.

The major stumbling point in the talks was the low level of market interest rates in Japan. The European representatives to the negotiations might have consented to even larger rate rises if the Japanese could have agreed to do the same. But with the long-term prime rate in Japan at only about 8.9%, Japan has refused to extend export loans at rates that would far exceed its market rates. The compromise finally worked out will have the Japanese extending Japan Eximbank export credits at no lower than 9.25%, with commercial bank portions provided at market rates.

The consensus reached in Paris was significant, particularly in combination with movement on other fronts. The governments of the United States, France, Germany, and Britain agreed only this past summer to establish an interest-rate minimum of 12% on loans for purchases of competing commercial jet aircraft. In addition, the agreement to tighten up on "prior notification" procedures in the extension of the controversial "mixed credits" (a blend of export credit and aid) will make it easier for countries to match mixed credit offers by others.

Subsidies for both aircraft and all other categories of capital goods and industrial plant exports, however, will remain excessive, particularly in Europe. Long-term government bond rates in France, for example, are currently 16.3%, while the new government-backed export credit rate on 10-year loans to developing countries is 10%. In Britain, the interest-rate subsidization scheme is estimated to have cost over $1 billion in the fiscal year ended March 1981.

For the United States, the rise in minimum export credit rates will mean that U.S. Eximbank-backed rates will be uncompetitive, rather than highly uncompetitive. The U.S. Eximbank has already cut back its subsidies sharply by raising its direct loan rate for medium- and long-term credits sharply to halt a deterioration in its net-income position. The bank's loose-fisted lending policies under the Carter administration —which chose to stress the bank's mandate to provide "competitive" financing over its mandate to remain "self-sustaining"—had it extending direct loans at about 8.0%-8.50%, while its borrowing costs shot up steadily in line with the rise in market rates. Moreover, the volume of direct lending under the former administration soared to more than $4 billion in fiscal 1980 from $700 million in fiscal 1977. The result was the prospect of an operating loss of $100 million in fiscal 1982.

Eximbank's new chairman, William Draper, responded to the problem quickly. Although he lifted a five-month-old moratorium on bank lending, he boosted the direct-loan interest rate in July to 10.75%

A Break in the Export Credits Stalemate

(continued from page 7)

from 8.75% and imposed a two-percentage-point up-front surcharge on Eximbank credit values. (On a 10-year loan, the bank estimates that the fee raises the interest cost of an Eximbank credit by ½ percentage point.) And on November 12, he boosted the bank's direct loan rate again to 12%. With respect to the allocation of its resources, the Eximbank will not provide credit support for export sales to developed or industrialized countries; will no longer extend general purpose "lines of credit"; will not finance old-generation aircraft; and will encourage greater use of financial guarantees of private credit. It will, however, continue to provide as much as 65% credit, in participation with private funds.

Recognizing the reduced financing competitiveness that its new direct loan rate policies entail—despite the increases in Arrangement minimums—the U.S. Eximbank is expected to reserve the right to extend repayment terms beyond the maximums specified in the Arrangement in special cases, an option that it has already exercised on several occasions. Furthermore, support from Congress and the administration for a "war chest," or emergency fund, to help the U.S. retaliate selectively against countries providing mixed credits and extending loans at the Arrangement minimums, is likely to persist. And Eximbank Chairman Draper has stated that by improving the bank's financial condition, the higher rates will allow the bank to target its resources more effectively to match foreign offers in important cases.

It is difficult to tell whether the U.S. Eximbank's powers of persuasion will be adequate to prod the Europeans and Japanese to consent to still further rises in the Arrangement rate minimums and ultimately to market-rate linkage. The United States hopes so. It will push for another three-percentage-point hike in minimum rates when the OECD Export Credits Group reconvenes in March.

America's competitors may, however, be disinclined to regard it as a serious challenger in the export credits race, with U.S. Eximbank loan activity curtailed and its loan costs high. For fiscal 1982, the Reagan administration has requested cutting back the bank's direct loan authority to $3.87 billion. This compares with a $5.02-billion ceiling in fiscal 1981 and with the $5 billion requested by the Carter administration for fiscal 1982. The Reagan government, in advocating reduced Eximbank lending, has maintained that the Eximbank's loans have little impact on expanding U.S. exports. Moreover, the U.S. Office of Management and Budget has stressed that only a few large firms which do not really need Eximbank support continue to benefit from the bank's loan program.

Still and all, there is a chance that the Eximbank's actual lending authority for fiscal 1982—as yet undecided—will exceed the $3.8 billion requested by the White House. Pressure from the business community did succeed in restoring about one-third of fiscal 1981 loan authority cut by President Reagan. And with U.S. unemployment at 8.0% and rising, there is sympathy for the argument about the adverse impact of Eximbank cuts on employment. In addition, Eximbank officials stress that since foreign governments continue to provide large subsidies, Eximbank aid is needed to neutralize them.

Regardless of funding levels, however, Eximbank's direct loan costs are likely to remain high. An Eximbank-backed 10-year credit to a buyer in a good-risk developing country is currently priced at 13.50%-14.00% per annum, exclusive of fees. This would entail Eximbank funds covering 50% of the overall credit, with a commercial bank loan at ½-1 percentage point over the London Interbank Offer Rate for the remainder. Such a U.S. "blended rate" compares poorly with those on export credits overseas. The comparable U.K., French and Italian rates, for example, are 10% (the new minimum), with the Japanese blended rate lower still.

In sum, the recent success in Paris will undoubtedly ease the level of trade-distorting subsidization of export credits by the industrialized nations. And it will take some of the pressure off the U.S. Eximbank to compensate in some fashion for its uncompetitive financing terms. Nonetheless, market rates in Europe and the United States are still far above the new minimum allowable export credit rates, keeping trade-distorting subsidies high and making the need for further increases in rates pressing. In addition, there exists a plethora of non-interest-rate subsidy schemes offered abroad—including inflation indemnity and exchange-rate fluctuation protection—that are outside the Arrangement's purview and that need addressing.

A real breakthrough in the export credits arena would be agreement on some mechanism whereby the Arrangement's minimum export credit rates will move permanently in line with market rates. The "managed system" agreed on in October, however, appears to be the most that is currently obtainable. Under this arrangement, OECD members will meet periodically to consider readjusting rate minimums, depending upon the prevailing interest rate of the IMF's Special Drawing Right. The U.S. hope is that Europe's willingness to boost minimum rates is indicative of a shift in philosophy, rather than a one-time accommodation, and presages further such increases at future review sessions toward the ultimate goal of subsidy-free long-term export financing.

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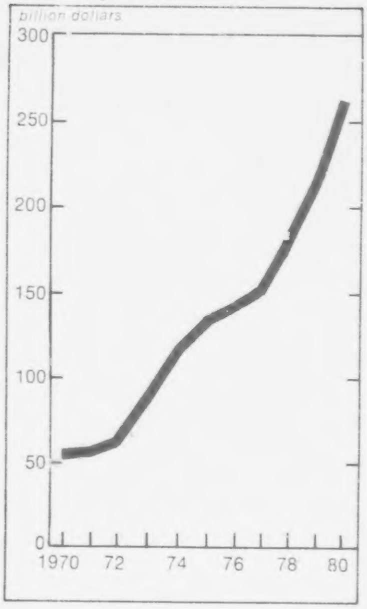
Weak World Economy Behind U.S. Export Slump

A great deal of concern is being expressed about the impact of the recent bout of dollar strength on the U.S. trade position. And demands for increased protectionist policies at home, as well as export subsidies to offset the dollar's strength, will likely become focal points for debate next year. Imports aside, concern over the United States' ability to compete abroad is likely to mount as U.S. export growth continues to deteriorate over the next few months. Available data appear to be supporting these worries: merchandise export growth in 1981 is estimated at only 7%-8%, compared with almost 30% in 1979 and 20% in 1980, and no recovery is seen until late 1982. The key question is whether it is indeed the recent strength of the dollar that is primarily responsible for the current slump in export sales.

U.S. exports



A strong dollar may well influence U.S. exports, but it does not appear to be the fundamental cause of the current sluggishness of U.S. foreign sales. The real culprit behind the export slowdown is the pursuit of restrictive monetary and fiscal policies, launched in late 1979 and carried out in 1980 and 1981. The pivotal change in U.S. monetary policy in late 1979 not only ushered in a period of dollar strength, but also precipitated a change in monetary and fiscal policy worldwide. In an attempt to avoid the inflationary consequences of loose fiscal and monetary policies—particularly in an environment of dollar strength—the United States' major trading partners reacted by tightening policy simultaneously, or at least with only a minor lag. The consequent coordination of worldwide monetary policy has thus resulted in decreased world trade, with economic growth in Europe, the United States, and the developing world taking a back seat to the fight against inflation.

The slowdown in global economic growth, then, is the main cause of the weakness in U.S. exports. The implications of currency fluctuations for the growth of world trade, despite popular beliefs to the contrary, are still not fully understood. The lesson that has been learned from the experience of the past decade is that currency fluctuations are, for the most part, results of policy actions that may or may not affect trade—but are not necessarily the primary causes of trade cycles.

1981—Economics Group, The Chase Manhattan Bank, N.A.

Determinants of sterling strength point to renewed U.K. economic growth.

Sterling has been extremely volatile in recent weeks, but the latest trend has been toward strength—with the pound rising from $1.86 at the start of November to $1.93 on November 25. Although some of this strength was the result of dollar weakness, sterling has also risen against the German mark. Much of sterling's vigor stems from the realization that the Thatcher government intends to stick with its restrictive policies. With the money supply still growing well above target, interest rates are thus likely to be kept high. Indeed, the Bank of England has been operating in the money markets to hold up interest rates in the face of sharp rate falls abroad. This has contributed to sterling's rise, but other influences are also at work. Balance-of-payments figures are being published once again, and September and October showed surpluses of £147 million and £316 million, respectively. These figures, together with surpluses recorded for January and February (the only other months for which figures have been published), suggest that Britain could post a surplus of some £5 billion for 1981 as a whole. A moderation in long-run inflationary pressures is also bolstering the pound. Wage increases averaged 11.1% in August and September, and there are signs that settlements in the current wage round will result in single-digit increases. Moreover, the cost of raw materials and fuels remained constant in October, and only small increases are seen for the near future. Thus, single-digit inflation in 1982 is a strong possibility. Many observers feel that the economy has reached a turning point. The government's policies to date have imposed a high cost in terms of reduced output and increased unemployment, but prospects for renewed growth coupled with relatively moderate inflation are now quite favorable.

Limits seen to Switzerland's tight money policy.

The restrictiveness of Swiss monetary policy since early September largely explains the recent strength of the Swiss franc vis-á-vis the German mark. The principal aim of the tighter money stance is to curb inflation—now running at over 7%—and current policy is indeed seen as consistent with this objective. Two factors, however, will temper the monetary authorities' resolve. First, the Swiss economy is entering a sharp contraction, which will persist well into the first half of 1982. Further Swiss franc strength would seriously impair export competitiveness and deepen the recession. Consequently, the central bank is expected to intervene to check any further climb in the exchange rate. Certainly, any move by the German Bundesbank to ease its monetary stance would be followed swiftly by a similar move in Switzerland. Second, the strength of the Swiss franc in terms of the dollar has already contributed to easing inflationary pressures. Although short-term influences may push the inflation rate higher, the outlook for inflation should be greatly improved in the first half of next year.

Dutch government funds new job-creation program.

With the latest official forecasts indicating real GDP growth of only 1.5% in 1982—following a contraction this year—and another large climb in unemployment, Holland's new government has consented to fund a job-creation program. The newly formed left-center coalition government has agreed to spend an extra 2 billion guilders for jobs, to be financed with a one-time rise in taxes and increased borrowing. The original goal of reducing the public-sector borrowing requirement to 6.5% of national income in 1982 from 8% in 1981 will therefore go unmet. Since about half of Dutch output is exported, however, developments elsewhere in Europe, rather than Dutch fiscal policy, will hold the key to fluctuations in aggregate demand and real GDP growth. On these grounds, a marked upturn in export demand—and thus in economic growth—is not expected before late 1982.

El Salvador's civil turmoil undermining economy.

El Salvador's civil war has taken a heavy toll on the economy. Last year, real GDP contracted by about 10%, with investment plunging by more than 60%. Construction and industry suffered the greatest losses, each dropping by 18%, while agricultural production fell 7%. In the external area, the current-account balance shifted into a deficit of $50 million, after having recorded a surplus of $130 million in 1979, and international reserves totaled less than $80 million at end-1980. Future economic prospects depend critically on political developments, which at this point promise further economic deterioration. Already, industry and transport have been severely disrupted by acts of sabotage, and concern is high that similar acts will be directed at agriculture as the harvesting of the country's major cash crops gets under way. Even apart from such worries, however, crop prospects for the 1981-82 harvest are poor because of reduced plantings, neglect of field work, and scarcity of credit and foreign exchange. Indeed, the 1981-82 coffee and cotton harvests are expected to be 10% and 30% smaller, respectively, than their previous year's low levels.

Worker remittances represent vital inflows for South Asia.

Since the mid-1970s, there has been a significant migration of labor from the countries of South Asia to the oil surplus countries of the Middle East. This emigration has resulted in a decline in productivity as experienced and skilled workers leave South Asia for higher pay. On the other hand, remittances from workers overseas have become a key source of foreign exchange and an important addition to household income and expenditure in South Asia. In the case of Pakistan—a fairly representative one—remittances now exceed disbursements of foreign assistance. Indeed, at $2.1 billion in fiscal 1980-81, Pakistani remittances were equivalent to 75% of export earnings and to more than 38% of imports. The future trend of remittances for the South Asian nations is highly uncertain, depending as it does on the oil earnings and political stability of the countries of the Middle East. The softness in oil markets may foreshadow an easing in the rate of growth of remittances. Such a slowdown, which appears likely, could have a significant balance-of-payments impact on the economies of South Asia.

Bottlenecks constrain Zimbabwe's economic growth; ample foreign aid a help.

After posting 9% real growth in 1980, the Zimbabwe economy is pressing up against serious foreign-exchange, transport, and skilled-labor constraints. These limitations point to a reduction in the economic growth rate to about 6% for 1981 as a whole. At the same time, upward pressure on prices has built, with the year-over-year inflation rate approaching 20%. In the external sector, stagnant export revenues and increased imports will swing the 1981 trade account into deficit by some $150 million from its traditional position of surplus. As a result, last year's $273-million current-account shortfall could widen to $675 million in 1981, leading to a tripling of the deficit in the overall balance of payments to an estimated $375 million. Resumption of faster economic growth and improvement of the trade account will have to await alleviation of transport problems and economic recovery in Zimbabwe's export-market economies. Meanwhile, the $1.8 billion in foreign aid and grants pledged by international donors should offer much-needed relief to the balance of payments through mid-1984.

A record wheat crop suggests near-term price softness.

World wheat production is expected to set a new record this year, despite the third consecutive year of poor harvests in the Soviet Union and dry growing conditions in the Southern Hemisphere. The U.S. Department of Agriculture projects the 1981-82 crop at 448 million metric tons, with significant rises in U.S. and Canadian output offsetting smaller harvests elsewhere in the world. World consumption is forecast at 446 million metric tons—up only slightly over 1980-81—owing to a substantial slowing in the growth rate of consumption of wheat as a food staple. With total consumption seen falling below production for the year, world stocks are expected to increase slightly after two years of decline. However, ending stocks as a percent of utilization, at 16.8%, will be only marginally higher than last year. This is still well below the 21% average stock-to-use ratio of the latter half of the 1970s. The United States will bear the major part of world wheat stock adjustment as it is expected to provide half of total world exports. With the United States thus serving as "residual supplier" of wheat worldwide, U.S. supplies will be critical to wheat price movements. Prices appear likely to remain weak in the near term, particularly in view of current prospects for a bumper crop of U.S. winter wheat. Prices could begin to strengthen later in 1982, however, as U.S. stocks are drawn down.

The U.S. Economy

New Tax Law May Reduce Business Borrowing

Although the main purpose of the new tax legislation is to provide greater incentives for capital formation, its immediate impact may be to influence corporate borrowing. As inflation has risen steadily over the past decade, the average corporate debt ratio (i.e., debt to total assets) of manufacturing firms has jumped from about one-third prior to 1970 to over one-half today.

The notion that firms tend to borrow more during inflationary periods is generally recognized, although the reason for this behavior is often misunderstood. One frequently overlooked explanation is that increased borrowing may be a conscious strategy to offset the adverse impact of inflation on the real value of corporate cash flow brought about by historical cost-based depreciation allowances. Given the validity of this hypothesis, the accelerated cost-recovery provision of the new tax legislation should serve to reduce corporate borrowing. And in view of the current weakness of the economy and the vulnerability of highly leveraged firms to downturns in earnings, this would be a positive development.

The most prevalent explanations for why corporations borrow more during inflationary periods are misconceived. Perhaps the most popular is that borrowers can benefit by repaying their loans with "cheaper" dollars, or, alternatively stated, in real terms they can borrow at below-market rates. What this argument neglects, however, is that lenders also anticipate the inflation rate and incorporate a compensating premium in the contractual interest rate, thereby removing the inflation-induced incentive to borrow. A second related argument is that, since neither party can predict the inflation rate with certainty, the inflation premium, after the fact, may fail to compensate the lender fully for the loss in purchasing power. But since both parties presumably learn from their mistakes over time, contractual interest rates should not systematically overestimate or underestimate the realized inflation rate.

A third popular, but incomplete, explanation rests on the observation that contractual interest rates represent an average of inflation expectations over the life of bonds. Thus, if corporations borrow when inflation is expected to accelerate, their borrowing costs will include an average of a lower, near-term inflation premium and a higher, long-term premium. Consequently, they will benefit in the long term when they are paying the lower average rate after the inflation rate has risen. The flaw in this argument, however, is that the average of the inflation expectations in the contractual interest rate will also overstate the inflation rate in the near term, offsetting the future savings.

If these justifications do not adequately explain the

Asia and Oceania Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE O				
			5 months ending	12-month change	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use cred lions d
Asia	**Bangladesh**	Development spending likely to be cut to prevent large budget overrun.	May	+10%	10.6*	$ 119	Sept.	148	— 16%	0.8	32
	Burma	Oil output has recovered to about 27,500 barrels per day.	July	— 3%	5.6*	174	Sept.	245	— 14%	7.3	4
	China, People's Republic	Strong growth of light industry offsets decline in heavy industrial production.	June	+15%	242.2	246	June	3,822	+ 10%	2.4	5
	Hong Kong	Government budget in surplus owing to strong manufacturing and real estate growth.	Sept.	+22%	21.5	4,290	n. a.	—	—	—	
	India	Largest loan in IMF history, for SDR 5 billion, approved.	June	—17%	172.6*	257	June	5,853	— 17%	5.8	3
	Indonesia	Oil production slows; good rice crop boosts rural income.	Mar.	+ 9%	66.3	437	Sept.	5,560	— 1%	5.2	
	Japan	Consumer spending signals revival, but small business investment and housing remain weak.	Aug.	+19%	1,044.0	8,940	Sept.	27,634	+ 20%	2.3	
	Korea	Government likely to adjust investment priority to finance 1988 Seoul Olympics.	Aug.	+26%	57.8	1,513	Aug.	2,023	— 39%	0.9	1,0
	Malaysia	Increased government spending and new business incentives proposed to spur economy in 1982.	June	—13%	22.8	1,697	July	3,994	— 6%	4.3	21
	Pakistan	Government pledges measures to restructure revenue system this year.	June	+23%	25.6*	311	Sept.	778	+ 71%	1.7	59
	Philippines	Local housing market depressed by recession and high domestic interest rates.	June	+10%	35.1	726	Sept.	2,010	— 19%	2.9	90
	Singapore	GDP growth slowed to annualized rate of 9.7% in third quarter, led by construction.	July	+ 8%	10.5	4,390	June	6,721	+ 8%	3.0	
	Sri Lanka	Government revamps turnover tax and extends its coverage to raise revenue.	May	— 3%	4.1	280	Sept.	237	— 30%	1.6	32
	Taiwan	Government takes measures to stimulate business investment.	Aug.	+13%	40.2	2,278	June	3,339	+124%	1.8	
	Thailand	Growth will slow as new five-year plan seeks to redress structural imbalances.	July	+10%	32.2	693	Sept.	1,393	— 33%	1.6	49
Oceania	**Australia**	Labor market turmoil continues; skilled labor immigration actively sought.	Aug.	+ 1%	138.2	9,454	Sept.	1,609	+ 20%	0.7	
	New Zealand	Some mineral projects being delayed because of anticipated cost overruns and upcoming election.	July	+ 8%	21.2*	6,714	Sept.	342	— 3%	0.7	7
	Papua New Guinea	Ok Tedi copper and gold project under way.	June	—35%	2.5	820	Sept.	379	— 17%	4.3	

*Fiscal year

observed relationship, the question still remains as to why firms tend to increase their borrowing in response to anticipated inflation. The answer lies in the distortion that inflation brings about in relative prices, since if all prices, including wages, rose at the same rate, economic activity would be unaffected. Specifically, for inflation to influence corporate borrowing behavior, it must affect the values of the elements of corporate cash flow differentially. In fact, two affected elements—depreciation allowances and repayments of bond principal—are fixed institutionally in nominal terms and cannot adjust freely to inflation in the way that wage costs often do.

Depreciation is a non-cash expense that is deductible for tax purposes, resulting in a positive cash flow. Since its magnitude is limited by the historical cost of plant and equipment, its relative value in real terms declines with inflation. Moreover, because of the failure of this positive cash flow to rise with inflation, there is a tendency for total corporate cash flow to decline in real terms. In the absence of any countervailing force, this development would serve to discourage investment activity, harming the economy as a whole. Fortunately, two countervailing forces are now at work. The most obvious is new tax legislation, which boosted depreciation allowances by shortening the useful lives of assets for tax purposes. The other, which firms have been utilizing for some time, is increased borrowing.

Borrowing is an effective strategy for offsetting the adverse impact of inflation on tax-related depreciation cash flows because bonds are issued in fixed denominations. Accordingly, when lenders seek to recover the real purchasing power of their principal, they must include the inflation-related portion in the contractual interest rate. Since the firm then deducts its interest payments for tax purposes, it receives an inflated tax-related interest benefit. Consequently, although depreciation does not keep pace with inflation, interest payments rise faster, so that the overall impact of inflation on total corporate cash flow is neutralized.

This hypothesis has important implications for the probable impact of the new tax legislation on corporate behavior. By recourse to debt financing, corporations have insulated themselves from the adverse effects of inflation. However, borrowing is not without its costs, and the excess reliance on debt has exposed firms in the current economic environment to an increased risk of financial difficulty. Now Congress has provided a safer alternative for preserving the real value of corporate cash flow. Although the law's intention was to encourage capital formation, it is reasonable to expect many corporations to use the additional cash flow to retire debt, since excessive leverage is no longer necessary to offset the adverse effect of inflation on depreciation. Although the law may not stimulate as much immediate investment as many expect, its influence in reducing corporate borrowing may be just as beneficial by strengthening corporate balance sheets to withstand the current downturn and prepare firms for future investment.

Carl Alan Batlin

PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				December 2, 1981			
IMF mil- dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars	change from year earlier	current monetary conditions	
	Import licenses restricted to conserve scarce foreign-exchange reserves.	July	+14%	June	+24%	.0525	−13%	Steps taken to slow credit growth.	**Bangladesh**
	U.S. economic assistance of $30 million accepted.	June	−4%	Oct.'80	+11%	.1360	−9%	SDR peg will bring kyat appreciation with dollar weakness.	**Burma**
	Partial Japanese financing arranged for certain Japanese projects in China.	Dec.	+8%	June	+26%	.5800	0	Treasury bonds sold to reduce money supply growth.	**China, People's Republic**
	HK dollar strengthens in response to high interest rates.	July	+15%	July	+3%	.1785	−10%	Money market tightens, but credit availability increases.	**Hong Kong**
	Import liberalization to continue.	June	+14%	May	−6%	.1100	−14%	Credit conditions to be restrictive under IMF program.	**India**
	Non-oil exports down; deficit seen for 1981 current account.	Sept.	+10%	June	+34%	.0016	0	Inflation slows because of soft food and oil prices.	**Indonesia**
	U.S. and EEC pressuring Japan to boost imports.	Aug.	+4%	July	+7%	.00464	0	Ceilings on overseas loans and on samurai bonds relaxed.	**Japan**
	Growth of letter-of-credit arrivals slows; foreign investment encouraged.	Aug.	+25%	Aug.	+4%	.0015	0	Interest rates lowered one percentage point.	**Korea**
	Import duties to be liberalized on a variety of goods.	June	+11%	June	+15%	.4454	−2%	Bank foreign-currency borrowing and lending to be allowed.	**Malaysia**
	Further measures to liberalize imports likely.	July	+13%	July	+17%	.1020	+1%	Credit conditions to continue tight under IMF guidance.	**Pakistan**
	Trade deficit of $1.98 billion recorded for first nine months of 1981.	Aug.	+12%	July	+11%	.1270	−4%	Money supply on 15% target growth path.	**Philippines**
	Heavy capital inflows continue, covering current-account deficit.	Aug.	+10%	June	+11%	.4878	+2%	Inflation and interest rates soften.	**Singapore**
	Depressed commodity prices help widen trade deficit.	June	+18%	June	+9%	.0520	−6%	Depreciation of rupee continues.	**Sri Lanka**
	Import of petrochemicals liberalized.	June	+18%	June	+13%	.0280	+1%	Interest rates lowered; mortgage financing to increase.	**Taiwan**
	Weak prices depress agricultural export receipts, despite strong volume gains.	Aug.	+11%	Apr.	+10%	.04[illegible]0	−5%	Credit conditions slightly easier.	**Thailand**
	Current-account deficit widening further.	June	+9%	July	+12%	1.1460	−2%	Campbell Report seeks sweeping financial liberalization.	**Australia**
	Export subsidy to be phased out gradually.	June	+15%	July	+5%	.8390	−13%	Government to restrict credit growth.	**New Zealand**
	Export earnings drop further with declining commodity prices.	June	+9%	July	−10%	1.4600	−4%	Money conditions stay tight; IMF loan obtained.	**Papua New Guinea**

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World Interest Rates

market rates of Dec. 2, 1981; bond yields as of Nov. 27, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00	15.32	14.375 intervention rate	13.00	9.50	7.50	19.00 penalty rate 22.00	9.00	6.00	6.25
Day-to-Day Money	12.50 December 3	18.75	15.00	9.60	15.50	11.00	20.375	11.00	5.00	7.375
Treasury Bills 91-day, Middle Rates	10.56 discount basis	15.15	13.9375	14.75	n. a.	n. a.	19.649 87-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	10.875 finance paper discount basis	15.75 finance paper 15% tax w/h	13.42	12.90 Certified	15.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	11.45	15.40 15% tax w/h	14.00	12.90 Certified	not traded	9.90	24.00	no market	9.75	no market
Government Bonds Long-term, new and old issues, average yield	13.10	14.75	14.76	10.74 20% tax w/h	16.09	9.76	21.57	11.35	5.57	7.87
Industrial Bonds prime, long-term, new and old issues, average yield	14.05 Aa Industrials	16.00	15.99	19.725	17.57	9.70	21.15	13.03	6.625	7.10
Bank Short-Term Rate to Best Borrowers (prime rate)	15.75	17.25	16.00	18.00	17.35	14.00	22.50 ⅛ quar'ly fee on outstdng.	13.00	10.50	6.75
Bank Time Deposits 3-month	11.625 Cert. of Dep.	15.00	15.00	14.35	15.375	10.55	10.75	11.375 large deposits	8.75 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	12.8125	no market	15.25	no market	18.00	10.5625	no market	11.50	9.875	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8492	1.9545	.0265	.1790	.4521	.000642	.4128	.5630	.00464
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	3.00 *D*	2.00 *D*	5.00 *D*	4.50 *D*	2.00 *P*	11.00 *D*	1.00 *P*	3.00 *P*	5.50 *P*

Eurodollar Deposits
(London, interbank, bid)
December 2

7-day	12.75
1-month	12.4375
3-month	12.5625
6-month	13.125

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.186
U.S.-Canada Treasury Bills	−0.839
U.S.-Canada Finance Co. Paper	−1.659
Eurodollars-U.K. Local Auth. Deposits	−0.1875

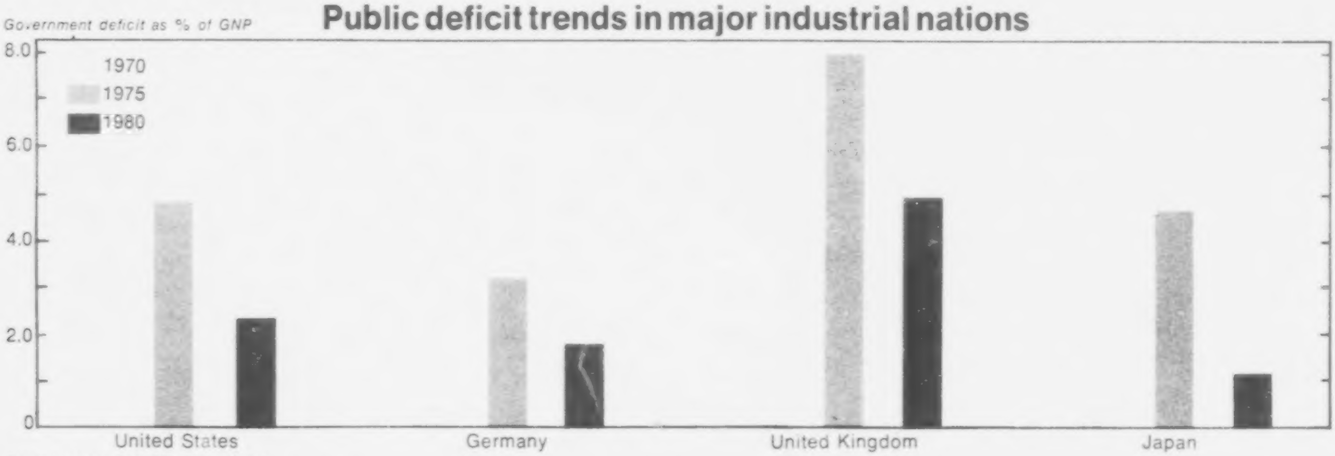
Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	14.50
Over 7 yrs.	14.75
DM Bonds	
7 yrs. and under	9.50
Over 7 yrs.	9.75

Gold Price
London
afternoon fixing

406.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.



Public deficit trends in major industrial nations

Data: International Monetary Fund

The Need for Balance

The following is excerpted from a speech given by **Willard C. Butcher,** *Chairman and Chief Executive Officer of The Chase Manhattan Bank, before the Economic Club of Detroit on November 23, 1981.*

The topic that has dominated the nation's attention since the very first days of the Reagan administration has been its economic package. I have been a supporter of the administration's economic program, although I have not agreed with each specific budget cut or policy nuance. Nonetheless, I do believe that the administration has put together an economic package whose long-term objectives are critical to restoring economic progress.

The problem, in my judgment, comes in the short term. There is simply no way, as President Reagan has reiterated, that this nation can avoid short-term problems of economic readjustment on its way to the longer-term promise of economic reemergence. What is needed in the short term is a carefully struck balance among the four elements of the program—spending cuts, tax cuts, deregulation, and monetary policy—not only to get us safely through this painful interim period, but also to ensure that we do not blunt the positive long-term effects.

In particular, there must be a balance between those aspects aimed at encouraging production and investment and those designed to control the money supply. Indeed, overly restrictive monetary policy—as noble as its inflation-fighting aim may be—could imperil the public's willingness to accept the short-term discomforts that are necessary to regain long-term economic growth.

The administration has offered a logical approach to the twin goals of lower inflation and greater economic growth. Both goals, I believe, are compatible and complementary. Some have erroneously insisted that inflation was an "inevitable companion" of growth; that "a little inflation" was even desirable. Nothing, to my mind, could be further from the truth.

Indeed, nothing is more detrimental to capital development and economic growth than inflation, because it erodes the very capital on which growth is based. And the administration's program implicitly recognizes that the rate of inflation is influenced not only by monetary policy but also by the growth of economic activity.

Monetary policy alone is simply not enough to curb inflation or cure our economic ills. In fact, excessive reliance on monetary policy may exacerbate our problems by dampening investment and inhibiting productivity growth. Moreover, in my view, monetary growth that reflects productive investment and economic expansion does not carry the same inflationary consequences as when money growth feeds consumption. In other words, it seems to me, that in assessing the appropriate stance of monetary policy, we must pay more attention to such factors as interest rates and what I would term the "qualitative aspects" of money flows—namely, the sources and uses of funds, particularly those used for saving and investment and, therefore, economic growth.

This argument was amply demonstrated in the 1950s and 1960s in Germany and Japan. During this period, high rates of monetary growth in Germany and Japan—9% and 12%, respectively—did not spur high inflation because they were accompanied by rapid, real economic growth.

As for the proper rate of money growth, we need to allow the money supply to expand in tandem with the economy and not be a drag on it or a prod to it. In essence, we need a more neutral, more consistent, and more predictable monetary policy.

In this context, if the current reduction in interest rates leads to a steadier monetary posture, then I believe it will prove beneficial in the long run. However, what we must avoid, in my view, is a return to the see-sawing, yo-yoing, roller-coaster rate course that has been such a punishing source of instability to our economy. If we reduce rates too fast and too far, we run a serious risk of a strong reaction—followed, in turn, by sharply higher interest rates. Such a course would be a real impediment to economic recovery.

My conclusion from all this is that embracing a single-minded approach to economic recovery—be it strict monetarism or any other theory—is not nearly as sound as adopting a more balanced and pragmatic approach, which requires judgment rather than dogma. In today's complex environment, any workable economic recovery program must be grounded in a more sophisticated view of the interplay between the money supply and inflation and between the growth in monetary aggregates and the expansion of productive investment.

That is why the other elements of the administration's program—deregulation, spending cuts, and tax cuts—are so critical. They are all aimed at freeing the economy to permit more efficient use of productive resources, which will in turn yield higher growth

The Need for Balance

(continued from page 7)

rates. And by seeking to encourage faster growth, these other aspects will enlarge the space in which monetary policy can be used to reduce inflation.

Deregulation is one example. Industries that are tightly regulated inevitably use resources inefficiently. They have little ability to do otherwise since the barriers to competition erected by regulations ensure that there will be no penalties for misusing resources. This is the case not only in our own regulated industries, but also in those European countries that have nationalized major industries. The inefficiency of these industries goes uncorrected and their nations' growth rates are constrained. Thus, in the United States, further deregulation should lead, over time, to less constrained economic growth.

The efficient use of our resources will be further enhanced by the second leg of the economic recovery program: *reduced government spending*. Government has tended to seek an ever-increasing portion of our resources for programs that take from, rather than add to, productive capacity. For example, 35% of federal spending is for income-transfer programs that promote consumption at the expense of saving and investment. If our economy is to grow more rapidly, the share of our resources devoted to building up productive capacity must increase. And this can only be achieved if fewer resources are allocated by the government and more are put to work by the private sector.

The third leg of the program, *tax cuts*, is designed to improve the use of resources by transferring economic decisions from the government to individuals. Economic decisions are made on the basis of comparisons between additional costs and additional benefits. High tax rates can alter the relationship between the risks entailed in new undertakings and the potential rewards. We had been embracing an incentive system that offered greater and more certain rewards for current consumption than for long-term investment. Fortunately, the administration's program of tax cuts has changed that equation. But here again, tax cuts must be balanced against spending cuts. We cannot make progress if tax cuts return more decisions to the private sector while increased government spending takes these decisions away.

Without the appropriate balance between tax cuts and spending cuts, the impact of our economic program on productivity and economic growth will be markedly curtailed. And without significant progress in improving productivity and economic efficiency, the potential for monetary control to do its job is severely hampered. Conversely, the more progress that is made in improving the quality of resource allocation, the smaller the burden monetary policy must shoulder in fighting inflation.

To repeat, if we put too much of a burden on monetary policy in the short run, we undermine the potential for growth and the reduction of inflation in the long run. Moreover, if we permit large federal deficits, and stoke the government's need to borrow, the entire short-run burden of adjusting to monetary control falls on the private sector. The federal government's demand for credit is insensitive to cost, so it is the private sector that is "crowded out" of the market because it is unwilling to invest when rates are so high that earning an adequate rate of return becomes improbable. On the other hand, I agree with Herb Stein that "if the private sector comes to expect greater stability in the long run and a stabilized monetary policy in the short run, private investment will itself become more stable and dependable."

Let me not be misunderstood. We will not solve our problems by weakening our resolve to control monetary growth. The last thing we need is "soft money". Rather, the solution lies in a more balanced approach to monetary policy along with deregulation, stricter control over government consumption and borrowing, and a reduced government deficit. And this means further cuts in government spending.

The more progress we make in improving the quality of resource allocation, the smaller the burden that monetary policy will have to shoulder to fight inflation. And with improved resource allocation, the more likely it is that an impatient American public will give the administration the time to demonstrate the wisdom of its economic strategy.

And time is precisely what is needed. Regrettably, now that it appears the United States is undergoing a recession, there is talk that we should cast away the fundamentals of our economic program, restore the spending programs that had been trimmed, and roll back the taxes that were cut. I suspect we will hear more of this talk if, as is expected, unemployment rises. But to heed these suggestions would doom our chances for economic recovery.

Our entire economic program is based on sound and sensible long-term policies for restoring economic health. To abandon any of the principal elements of this program at this time would undermine its credibility, increase economic uncertainty, and deprive our nation of the benefits of the first coherent plan in decades to get us back on the track of growth and productivity.

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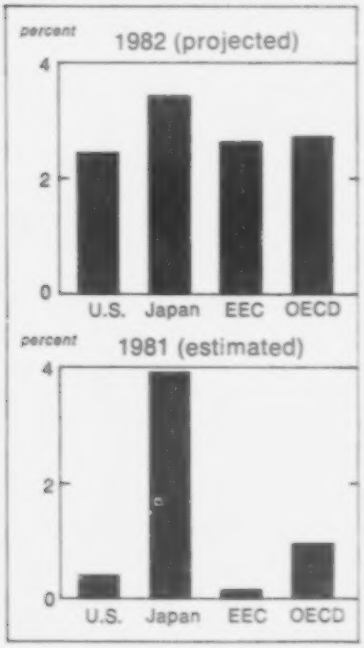
The World Economy in 1982—No Replay of 1981

The performance of the world economy is likely to improve significantly in the coming year. On a fourth-quarter to fourth-quarter basis, real output in the OECD countries should increase by roughly 2½% in 1982, distinctly better than the 1.0% growth achieved last year, but insufficient to prevent an increase in the overall OECD unemployment rate. Measured on a yearly average basis, however, the increase in OECD growth will appear to be insignificant–1.3%, compared with 1.0% in 1981. World trade volume, flat last year, will grow by about 2%. And inflation rates will fall in virtually all OECD countries. The major industrialized economies will not be closely synchronized over the first half of the year. The United States is entering the new year amidst a sharp recession; in Europe the first signs of an upturn are already apparent. By midsummer, however, recovery should be well under way in most of the industrialized countries, with growth in the United States outpacing Europe, and possibly even Japan, in the second half of the year.

The 1982 outlook is not all that different from the forecast for 1981 that appeared here a year ago–a projection that proved much too optimistic. The key source of error in last year's outlook was the failure to foresee the persistence of unprecedentedly high U.S. interest rates, a development that led in turn to a remarkable strengthening of the dollar and a defensive tightening of fiscal and monetary policies in Europe and Japan. These high interest rates resulted from the collision between a Federal Reserve dedicated to stricter control of money growth and an economy that proved extremely reluctant to revise its inflation expectations. The obvious question is whether history will repeat itself, with tight monetary conditions short-circuiting the upturn in the United States, and the global economy continuing in the stop-go pattern of the past two years.

The judgment here is that the inevitable re-tightening of U.S. monetary conditions later this year will not be so severe as to prevent a significant recovery in real output. The key difference between this year and last is the shift in inflation expectations. There is increasing evidence that price expectations in the United States are being revised downward. If this development continues, the coming year will not be a replay of 1981, and the global economy will at long last begin a slow but reasonably sustained recovery from the world recession set off by the second round of oil-price increases.

Projected economic growth in 1982 compared with 1981
(Change in real GNP, 4Q to 4Q)



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WESTERN EUROPE

Although the recession in Western Europe has bottomed out, the upswing currently under way is expected to be one of the slowest on record. The sluggish recovery reflects the changed attitudes of many European economic policymakers, who are reluctant to adopt expansionary fiscal and monetary policies for fear of worsening already-high inflation rates and widening balance-of-payments deficits. Thus, barring governmental stimuli, growth in Western Europe will depend first on an end to the rundown of inventories, subsequently to some stockbuilding, and later to growing exports and rising consumption—a process that is likely to be extremely slow.

In the **United Kingdom,** the government continues to hold to its restrictive fiscal and monetary stance, although both public expenditure and money supply growth remain well above target. There are signs that the economy's steady decline since mid-1979 has halted and that the country is now set to resume slow growth. Firms have shed a lot of surplus labor, and productivity has began to rise—a trend that should accelerate as output expands. Inflation remains high, but this year's wage round has begun well, and it appears that single-digit earnings growth will be the norm. This would contribute to a 1982 inflation rate only slightly above 10%, accompanied by positive real economic growth of about 0.7%.

A consumer-led recovery is expected to boost real GDP in **France** by nearly 3% in 1982, although an average inflation rate approaching the 13.5% posted in 1981 is forecast. The growth resurgence is projected to widen the current-account deficit to about 60 billion francs from 35 billion francs in 1981.

After strong growth in 1980 and early 1981, business activity in **Switzerland** is now in a pronounced downspin. Real GDP growth of no more than 0.5% is expected in 1982, although the current-account surplus should widen to 5 billion Swiss francs from SF 2 billion in 1981. Inflation is expected to fall sharply over the course of the year, helped by the economic contraction and a strong franc, but the average rate will approach 6%.

West Germany's recovery is not expected to gather steam until midyear, although a weaker U.S. dollar would accelerate the expected reduction in interest and inflation rates and spur a faster recovery. Real growth of 1.5% is forecast for 1982, after a slight contraction last year. The inflation rate is expected to drop to 5%, and the current account is likely to post a small surplus, the result of heightened export competitiveness and improved trade terms.

Italy continues to suffer a large balance-of-payments deficit, a major short-term constraint on its growth. Real GDP is expected to increase by about 1% this year, with monetary policy continuing restrictive. The current-account deficit is forecast to narrow to $6 billion from $10 billion last year. Inflation is projected to drop slightly to 17%.

The **Scandinavian** economies, whose business cycles usually lag those elsewhere in Europe, are more closely synchronized in the current environment. **Denmark, Norway,** and **Sweden** are expected to see growth pick up from its 1981 pace. But **Finland's** economy may slow slightly in response to restrictive policies to quell economic overheating in 1979-80.

WESTERN HEMISPHERE

As a consequence of the U.S. and world economic slowdown, **Canada's** real GDP grew by only 2% in 1981, with the likelihood of an even slower pace in 1982 induced by a restrictive federal budget. Inflation averaged nearly 13% last year, but the expectation of smaller food price rises could reduce the inflation rate in 1982.

For the Latin American-Caribbean region, 1981 is likely to be remembered as one of the poorest years in recent economic history. Real economic growth region-wide is estimated at 1.5% at best, versus 5.4% in the previous year. The reasons include the recession in the industrialized world, worsening terms of trade, rising interest rates, and generally more restrictive demand-management policies aimed at checking inflation and balance-of-payments deterioration. In Central America, the principal cause of the economic slowdown in 1981 was widespread political disturbance. The Latin American outlook for 1982 is for a rise in the rate of real growth to about 3%, still well below the 4.8% annual average growth rate between 1975 and 1979. The growth expected will be based largely on the recuperation of the Argentine and Brazilian economies and continued strength in Mexico, the countries contributing most to the region's GDP.

Argentina will face an uphill battle in achieving positive economic growth and lower inflation after the output decline and price surge in 1981. **Brazil** recorded a large trade surplus and cut its inflation rate in 1981, but at the cost of a recession; real GDP is likely to recover in 1982, however. And **Mexico** will see its real economic growth rate slow slightly to a still-strong 6% in 1982.

In the Andean Group, **Venezuela** should experience growth of some 2%—if steps are taken to reactivate the economy after three years of stagnation; inflation is likely to stabilize at around 10%. **Ecuador** will attempt to stimulate new oil output to boost its lagging economy. Although **Colombia** experienced a business slowdown last year, the implementation of large investment projects brightens 1982 prospects. In **Peru,** growth is not likely to exceed the 4.5% rate of 1981, and inflation is expected to continue high in light of a large fiscal deficit. A period of economic stagnation is seen for **Chile,** with the inflation outlook dependent on exchange-rate policy. **Uruguay's** economy is also expected to show no growth in 1982, while the **Paraguayan** economy is expected to proceed on a sustained, albeit modest, growth path.

The Central American outlook is bleak. **Nicaragua's** recovery is proceeding slowly, hampered by political uncertainty and a foreign-exchange squeeze. Civil unrest in **Guatemala** and **El Salvador** is worsening, while **Honduras** is plagued by its proximity to the trouble spots. And **Costa Rica** is seeking to reschedule its foreign debt of $2.6 billion. **Panama** stands apart, with favorable growth prospects for 1982.

In the Caribbean, **Trinidad** and **Tobago** will continue to realize solid gains from oil and gas, while the **Bahamas** should experience a tourism revival by late 1982. The **Dominican Republic's** external-payments situation may continue to worsen this year, given the sugar price outlook. **Jamaica's** economic recovery is proceeding slowly, while **Puerto Rico's** economy is expected to stagnate in response to U.S. weakness.

ASIA-OCEANIA

The major impetus to **Japan's** growth in 1982 is likely to be domestic demand, in contrast to the export-led growth of the last two years. The pickup in domestic demand, however, is unlikely to compensate fully for the expected slowdown in net exports, and real growth will probably total only about 3.5% this year. Inflation will remain moderate, with consumer prices forecast to rise by an average of 3%-3.5%. The yen's appreciation, the sluggishness of the U.S. and European economies, and strong protectionist pressures will result in much slower export growth this year. But with import growth likely to remain moderate, the current-account surplus is expected to widen to about $12-15 billion from $6 billion in 1981.

South Korea should experience a second year of recovery from its 1980 recession, and real economic growth of 6%-7% can be expected in 1982. The current-account deficit, nevertheless, will remain at about $5 billion, and the inflation rate is forecast to stay at well over 10%. **Taiwan's** economic growth rate is also projected at 6%-7%, but its deficit on current account is not expected to top $1 billion and inflation should be in single digits. **Hong Kong** may have problems sustaining its recent 8%-10% growth rate, with its exports under strong competitive pressure. **Singapore's** role as a service center for the oil industries of Indonesia and Malaysia makes it less vulnerable; real growth of over 8% is possible in 1982.

The **Philippines** continues gripped by recession. In the absence of a rise in the prices of its main export commodities, growth in 1982 will be less than 5%, with a large balance-of-payments deficit likely. **Thailand's** excellent crops in 1981 should support export volume this year, while the new gas pipeline from offshore fields will limit oil imports. Consequently, a modest improvement in the payments balance is forecast, with overall growth of 6% and inflation of 10%. **Malaysia** is expected to sustain a stable growth rate of around 7.5%, with its current account in near balance. **Indonesia** is in the midst of a large capital spending program, and, with stable oil earnings, its current-account deficit could reach $3 billion this year. Although there have been calls in **China** for a shift of resources back to heavy industry and construction, Premier Zhao has supported a plan and budget for 1982 that maintain strict budgetary controls. Moderate economic growth of 4% is projected for 1982.

The pace of resource development will be the primary determinant of economic growth in Oceania. Real economic expansion in **Australia** is likely to total 3.5%-4%, inflation is expected to be around 11%, and a large current-account deficit is forecast. In **New Zealand,** real growth of only 1.5%-2% is probable, but inflation may exceed 15%.

MIDDLE EAST-AFRICA

Sluggish world demand for OPEC oil resulted in smaller price rises and an output reduction of 15% in 1981. The OPEC surplus on current account narrowed to an estimated $65 billion from $108 billion in 1980. Continued weak demand for OPEC oil, coupled with the freeze imposed on oil prices, will shrink the OPEC surplus further to no more than $40 billion in 1982.

Although **Saudi Arabia's** oil revenues will fall noticeably this year, its outlays for development and national defense will accelerate in the context of a new five-year plan. Despite lower petroleum earnings, government spending will also remain buoyant in the **UAE** and **Oman.** In **Kuwait** and **Qatar,** however, public-sector outlays will be restrained in 1982. **Tunisia's** prospects are brightened by two oil finds and more direct investment by Arab oil exporters. But despite the expected growth of phosphate exports, **Morocco's** economy will be hurt in 1982 by a prolonged drought that will boost food imports and expand the trade deficit. And **Egypt's** current-account gap will widen substantially this year because of slower export growth. **Iraq's** development drive has continued unabated, financed by exports through the Mediterranean pipelines and heavy Arab aid. **Iran's** position is weaker, but recent oil export increases have helped. The lack of agreement over gas export prices and soft oil demand have weakened **Algeria's** external position. **Syria's** balance of payments is similarly weak, but the **Jordanian** economy has continued to prosper, thanks to aid grants and remittances. In **Israel,** inflation could average above 100% in 1982, barring new, well-defined policy initiatives.

Slower growth, deteriorating terms of trade, and rising external-debt loads characterized the economies of Sub-Saharan Africa in 1981. Regional real GDP growth, 4.7% last year, is projected to decelerate to 3.5% this year, with poor prospects for African raw materials exports. With the exception of the minor oil producers—**Angola,** the **Congo,** and **Gabon,** which posted current-account surpluses last year—current-account deficits elsewhere in Africa widened, and little if any improvement is seen for 1982. The two major economies, **Nigeria,** and **South Africa,** saw their current accounts swing from $3.4-billion surpluses each in 1980 to deficits of more than $8 billion and $5 billion, respectively, last year, as Nigeria's oil receipts shrank because of reduced demand while South African gold earnings suffered. This year, reduced imports should trim the deficits, with foreign capital providing the needed finance. Most African economies, however, face another year of continued heavy dependence on concessional aid, with the IMF's supervisory role widened.

COMMODITIES

The worldwide economic slowdown is reflected in sagging international commodity prices. Industrial commodity markets continue to suffer from slack demand and producer overcapacity, while the outlook for agricultural commodities is dominated by abundant harvests and burgeoning supplies.

The growing consensus that any turnaround in the industrial economies is likely to be tenuous—at least until midyear—suggests that the industrial metals face a six-month period during which demand will continue quite weak. A slow recovery is expected for **aluminum,** in light of record stocks and perhaps the worst recession the industry has ever known. Despite significant price cuts, the **nickel** market is expected to remain in the doldrums as long as the steel industry continues depressed. Strikes in North America and Ireland enabled **zinc** producers to raise prices substantially last year, despite weak demand; however, prices now appear to be leveling off. In the depressed **copper** industry, stocks are abnormally low, owing to high interest rates, and there is some chance of a sharp rise in prices should the economy show unexpected vigor. Given the prospect of continued sales of **tin** from U.S. stockpiles in an already thin market, prices are likely to remain under downward pressure. In the **lead** market, strikes and lower supplies of scrap have trimmed stocks, suggesting price firmness.

High interest rates, progress in stemming U.S. inflation, and a strengthening of the dollar over the past year have helped bring **gold** and other precious metals prices more in line with supply and demand fundamentals. Oversupply in the **silver** market is likely to keep prices near their current low levels. No strong rebound in **platinum** prices is expected as long as the U.S. auto industry remains depressed.

World grain production, including **wheat, rice,** and **coarse grains,** is expected to set new records, while grain consumption will show a more modest rise, leading to downward pressure on prices. Higher **poultry** consumption, as well as the general weakness of the developed economies, continues to discourage demand for **beef** and **pork.**

Aided by government subsidy programs and near-ideal growing conditions, the 1981-82 **sugar** harvest will set a new record, suggesting little if any price recovery in 1982. Since consumption will fall far short of this year's bumper **coffee** crop, prices are likely to remain weak. And **cocoa** price softness will continue in view of a fifth consecutive surplus season.

Sluggish textile activity, combined with bumper crops in the United States and China, will keep **cotton** prices down early in the year, although they may rise slightly if the world economy improves. And **rubber** prices seem likely to stay low in the near term.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
												12-month changes				exchange rate in U.S. dollars	change from year earlier		
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	December 29, 1981		current monetary conditions	
Argentina	New president cites fiscal austerity and cut in state role in economy as major goals.	Mar.	− 8%	117.0	$4,333	Aug.	3,751	−60%	5.0	0	Unified foreign-exchange market replaces two-tier system.	Nov.	+120%	Oct.	+127%	.00014	−72%	Banks may accept fixed-term, foreign-currency deposits.	**Argentina**
Bahamas	Economic slowdown precipitated by tourism decline, but construction holding up.	Mar.	− 9%	1.2	5,630	Oct.	127	+27%	1.9	0	Tourism earnings declining because of U.S. recession and dollar appreciation.	Aug.	+ 10%	June	+ 10%	1.01	0	Liquidity at low level.	**Bahamas**
Barbados	Oil imports to cost $40 million this year; government giving priority to energy conservation measures.	June	− 3%	0.8	3,055	Oct.	64	−28%	1.4	2	Imports and exports in first-half 1981 up 11.8% and 11% from year ago.	Aug.	+ 14%	Aug.	+ 13%	.4972	0	Discount rate raised to 22%.	**Barbados**
Brazil	Adjustment program producing lower inflation, but GDP growth in 1981 was either zero or negative.	Oct.	+10%	233.2	1,896	Oct.	5,468	0	2.7	0	Balance of payments improving as consequence of stabilization measures.	Nov.	+ 99%	Nov.	+ 66%	.0079	−51%	Liquidity supply expands slightly.	**Brazil**
Chile	Central bank has assisted eight financial institutions; several major companies bankrupt.	Sept.	−14%	22.8	2,060	Oct.	3,317	+13%	5.2	54	New mining law and associated laws approved to spur foreign investment.	Nov.	+ 14%	July	+ 70%	.0260	0	Interest rates rising.	**Chile**
Colombia	Cumulative inflation rate for first 10 months of 1981 rose to 22.6%; food items posted biggest rise.	June	−39%	36.8	1,360	Oct.	4,501	− 4%	10.7	0	Current-account gap of $591 mn. for Jan.-Aug. 1981 vs. surplus year earlier.	Oct.	+ 26%	Apr.	+ 25%	.0200	0	Effective interest rates reach 50%.	**Colombia**
Costa Rica	Government having problems renegotiating $2.6-billion foreign debt.	June	− 1%	5.0	2,190	Oct.	101	−32%	0.9	106	Currency devalued; import license requirement eliminated.	Aug.	+ 39%	Apr.	+ 37%	.0600	−50%	Monetary policy is restrictive.	**Costa Rica**
Ecuador	Economic activity sluggish as result of policy restrictiveness and low oil-export price.	May	− 9%	11.0	1,321	Oct.	707	−18%	3.7	0	Weak non-oil export showing putting pressure on current account.	Sept.	+ 17%	June	+ 12%	.0310	−18%	Monetary stance becoming more restrictive.	**Ecuador**
El Salvador	Private investment fell 51% in 1980 and possibly even more last year.	June	−73%	3.4	709	Oct.	71	+ 1%	0.9	43	Sale of foreign exchange halted for travel abroad to stem capital outflow.	June	+ 15%	Aug.	0	.4050	0	Foreign reserves continue falling.	**El Salvador**
Guatemala	Oil output in 1982 could total 13,000 bpd, enough to satisfy over half domestic needs.	Dec. '80	+ 1%	7.9	800	Sept.	187	−62%	1.3	0	IMF approves two loans totaling about $110 million.	Aug.	+ 12%	July	+ 7%	Par	—	Liquidity is tight.	**Guatemala**
Jamaica	Bauxite prospects brightened by U.S., Soviet, and Venezuelan supply agreements.	Sept.	+ 7%	3.2	1,460	Sept.	79	−44%	0.6	468	Outlook for tourism favorable for winter season.	Sept.	+ 9%	Aug.	− 16%	.5700	0	Monetary stance is conservative.	**Jamaica**
Mexico	Industrial production up 7.6% in first seven months of 1981, versus 9.2% rise in year-earlier period.	June	+35%	167.0	2,300	Apr.	3,154	+37%	1.5	0	Agricultural exports up 32% in Jan.-Aug. 1981 vs. 4% decline year earlier.	Oct.	+ 28%	June	+ 34%	.0382	−13%	Demand for peso credit is strong.	**Mexico**
Nicaragua	Government returns approximately 900 coffee plantations to original owners.	Dec. '80	−22%	2.1	780	Dec. '80	70	−53%	1.0	24	Current-account gap may have narrowed to $300 mn. with cash crop revival.	Mar.	+ 25%	Dec.	+106%	.1000	0	Net foreign assets declining.	**Nicaragua**
Paraguay	Economic growth rate was 8%-9% in 1981, down from 11.4% in 1980.	Aug.	+19%	4.6	1,505	Oct.	772	+ 4%	16.9	0	Export receipts fell in 1981 because of lower commodity prices.	Apr.	+ 16%	Aug.	+ 9%	.00795	0	Domestic credit very limited.	**Paraguay**
Peru	Large public works program will get under way in 1982 and boost construction sector.	Sept.	−17%	17.2	965	Nov.	736	−62%	2.3	399	Higher rate of monthly sol/dollar devaluation in effect since September.	Nov.	+ 72%	Oct.	+ 48%	.0023	−34%	Reserve requirement being reduced gradually.	**Peru**
Puerto Rico	GDP to drop in fiscal 1982, reflecting U.S. recession, reduced federal transfers, and lower investment.	Sept.	+ 2%	11.4	3,530	Sept.	11,061*	+27%	—	—	Trade prospects dim in view of U.S. economic showing.	Oct.	+ 10%	Sept.	+ 14%	Par	—	Commercial bank deposits rose sharply in April-Sept. period.	**Puerto Rico**
Uruguay	Economic activity slows as exports drop.	Aug.	+32%	9.8	3,825	July	403	− 5%	3.0	0	Fiscal incentives offset overvalued exchange rate.	Oct.	+ 30%	Aug.	+ 33%	.0900	−17%	Net foreign assets declining.	**Uruguay**
Venezuela	Sugar industry in deep crisis; annual domestic production has plunged by over 50% since 1974.	Aug.	+18%	51.4	3,690	Nov.	8,401	+15%	8.4	0	Capital outflow significantly reduced since interest-rate adjustment.	Oct.	+ 13%	May	+ 14%	.2330	0	Domestic interest rates above international levels.	**Venezuela**

*Total bank deposits in commercial banks

World Interest Rates

market rates of Dec. 29, 1981; bond yields as of Dec. 25, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	17.25	13.8125* intervention rate	15.00	9.50	7.50	19.00 penalty rate 22.00	9.00	6.00	5.50
Day-to-Day Money	13.125 December 30	13.00	14.75	13.00	15.375	10.00	20.625	10.00	1.50	6.6875
Treasury Bills 91-day, Middle Rates	11.66 discount basis	14.70	14.875	16.00	16.09 one-year	n. a.	19.898 90-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	11.50 finance paper discount basis	15.75 finance paper 15% tax w/h	13.886	14.90 Certified	15.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	12.70	15.60 15% tax w/h	14.875	14.90 Certified	not traded	9.90	24.60	no market	10.25	no market
Government Bonds Long-term, new and old issues, average yield	14.17	15.875	15.44*	11.11 20% tax w/h	15.85	9.17*	21.23	11.30	5.38	7.672
Industrial Bonds prime, long-term, new and old issues, average yield	15.10 Aa Industrials	16.50	16.38*	16.91	17.29	9.90*	20.92	12.92	6.50	7.16
Bank Short-Term Rate to Best Borrowers (prime rate)	15.75	16.50	15.50	18.00	16.85	14.00	22.50 ⅛ quar'ly fee on outstdng.	13.00	10.50	6.00
Bank Time Deposits 3-month	13.00 Cert. of Dep.	15.75	15.625	15.50	15.375	10.65	10.75	11.00 large deposits	8.75 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	14.1875	no market	16.125	no market	17.625	11.00	no market	11.0625	10.0625	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8446	1.9000	.0259	.1745	.4410	.000828	.4020	.5561	.00451
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.00 *D*	2.00 *D*	5.70 *D*	3.00 *D*	3.00 *P*	10.00 *D*	3.00 *P*	3.00 *P*	6.00 *P*

Eurodollar Deposits
(London, interbank, bid)
December 29

7-day	14.375
1-month	13.75
3-month	14.0625
6-month	14.8125

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.011
U.S.-Canada Treasury Bills	− .328
U.S.-Canada Finance Co. Paper	−2.034
Eurodollars-U.K. Local Auth. Deposits	+ .5625

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	16.00
Over 7 yrs.	15.50
DM Bonds	
7 yrs. and under	10.00
Over 7 yrs.	9.50

Gold Price
London
afternoon fixing
397.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of Dec. 23; bond yields as of Dec. 18, 1981.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	9.6 (Nov.)	12.2 (Nov.)	12.0 (Nov.)	14.3 (Nov.)	6.6 (Nov.)	18.2 (Nov.)	7.0 (Nov.)	3.6 (Nov.)
Industrial production*	−1.8 (Nov.)	−1.5 (Oct.)	0.8 (Oct.)	−1.5 (Oct.)	−1.9 (Oct.)	−2.9 (Oct.)	−2.6 (March)	6.0 (Oct.)
Trade balance† *(billions of local currency units)*	−$4.41 (Nov.)	C$0.71 (Oct.)	£0.03 (Nov.)	−FF6.43 (Nov.)	DM3.95 (Nov.)	−Lit.0.41 (Oct.)	−SF0.26 (Nov.)	¥139 (Nov.)
Money supply (M1)*	4.5 (Nov.)	4.0 (Aug.)	10.2 (Aug.)	11.6 (June)	1.4 (Aug.)	11.2 (June)	−2.5 (July)	3.0 (Aug.)
Velocity of money (M1)*	12.7 (March)	6.7 (June)	10.2 (Dec. '80)	n. a.	1.3 (June)	4.5 (June)	n. a.	2.7 (June)
Reserves minus gold *($ million, change from previous month)*	540 (Oct.)	−194 (Oct.)	−162 (Oct.)	−172 (Oct.)	−3,177 (Oct.)	−190 (Oct.)	−1,402 (Oct.)	466 (Oct.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

The U.S. Economic Outlook

The recession in U.S. economic activity gathered momentum late in 1981. Industrial production began to decline in August, and the rate of descent then accelerated. Unofficial estimates of total output (real GNP) for the fourth quarter indicate that it was no higher than two years earlier. A further decline is expected in early 1982, when the unemployment rate may exceed 9%. Only a few sectors of the economy currently show any real strength; defense spending is the principal example.

Nevertheless, there have been a number of encouraging developments in recent months. The sheer speed of the cutback in industrial production indicates that industry is moving vigorously to curb inventories—an essential part of the process that eventually ends recessions. Moreover, short-term interest rates have declined substantially, and the rate of price inflation shows signs of abating.

If the consensus view of the outlook is correct, the recession should hit bottom some time in the spring. The pace of recovery may be modest for the first few months. But, as of July 1, 1982, individual income tax rates will be reduced by 10%, and Social Security benefits (which are untaxed) will increase significantly, probably by 8%-9%. These are expected to generate a significant increase in personal consumption, which in turn should stimulate investment. Economic growth could therefore be vigorous in the second half.

For the next few months, however, news about U.S. production and income is likely to remain quite negative. Industrial output will continue to decline, reflecting the necessary adjustment of business inventories. Reductions in production activity will further erode income and limit consumption. Among the most obvious victims of this process will be—as in the past few months—sales of automobiles, especially domestic models. Although sales of U.S. models are near bottom now, material improvement is unlikely before spring. Sales of other consumer durables have also been badly undercut.

Residential real estate activity has been most severely depressed by the high interest rates of the past two years. Construction was probably begun on fewer than 1.1 million new housing units in 1981. Lower interest rates should bring some recovery, although with a considerable lag in view of the damage already wrought. For this reason, total housing construction may not be much higher in 1982 than in 1981. By yearend, however, the rate of new housing starts could easily be up by 30%-40%—but still about one quarter below the average for all of the 1970s.

Business capital investment has held up rather better than these other highly cyclical sectors, although it now appears to be slipping. Investment in 1982 will be subject to opposing influences. Among the negatives: the existence of substantial excess capacity (manufacturing's operating rate is now under 75%), and interest rates that, while down from their peaks, are still historically high. A strong plus: greatly improved depreciation rules and other incentives enacted last summer. On balance, the influences on investment imply modest weakness through much of 1982. Late in the year and in 1983, this sector could be expanding rapidly.

Because it is beginning at such low levels, 1982 promises to be unprepossessing; GNP and some of its key components, notably autos and housing, are likely to show little change from 1981. Viewed yearend to yearend, however, 1982 looks much more promising, with real growth of about 2½% forecast and the rate of consumer price inflation falling to around 7% from 9% in 1981.

Monetary policy and interest rates

Nominal economic growth in 1982 estimated at 9% (roughly 2% "real", with 7% inflation) suggests a strong likelihood that the Federal Reserve's announced money growth targets will come under pressure during the year. Accordingly, periods of rising interest rates are also in prospect for 1982.

Over time, money turnover, or velocity, has tended to rise by approximately 3½% annually. Assuming this trend figure, the narrow money stock would have to rise by 5½% to accommodate a 9% rise in U.S. GNP. Such growth is at the top of the Federal Reserve's announced 1982 target of 2½%-5½% growth. To be sure, a variety of factors could temper a collision between money targets and GNP growth—these include a more rapid velocity, a change of the targets, or simply an accommodation of more rapid growth by the Federal Reserve without higher interest rates.

Given the expectation of a relatively weak economy well into 1982, money demand should tend to be "manageable" by Federal Reserve standards for some months to come without sizable interest-rate movements in either direction. (This does not, of course, mean materially less short-run rate volatility.) On balance, there is some seasonal tendency for rates to move down early in the year, and 1982 should be no exception. In the latter part of the year, however, the spending rebound will mean accelerating money growth, with the result that interest rates are likely to rise—possibly sharply at times. For 1982 overall, money market rates, such as a federal funds and 90-day certificates of deposit, are expected to average in the neighborhood of 12%-14%, somewhat below the 16% average of 1981.

The U.S. Economic Outlook *(continued from page 7)*

As for financing activity, total credit-market borrowing will approximate $500 billion in 1982, about the same as in 1981. Residential mortgage activity will show little improvement until the second half, with overall volume only a bit better than the 1981 disaster. Consumer credit will also be marginally higher. The main swing factors are government borrowing—$20-30 billion higher than in 1981—and business financing, about $20 billion lower.

The business financing gap—investment and inventory outlays minus cash flow—is projected to narrow sharply in the first three quarters of 1982, rising toward the 1981 pace of $50 billion only late in the year. After bottoming out in the first quarter, both fixed investment and inventories should increase steadily as the recovery gets under way. Cash flow, aided by the larger available depreciation allowances, should decline less markedly early in the year, despite lower earnings, and should also respond quickly to the recovery in economic activity. Even if firms continue to build up liquid-asset positions at the same rate as in 1981, the outlook for total financing in 1982 will be approximately $85 billion, compared with $115 billion in 1981.

The distribution of these reduced credit demands is expected to emphasize more recourse to medium- and longer-term debt. Of course, this represents a reversal of the pattern that prevailed in 1981, when there was heavy use of short-term facilities such as bank loans and commercial paper. This shift is predicated on an improved investor interest in longer-maturity instruments as inflation rates show continuing signs of improvement. To be sure, the huge financing needs of the U.S. Treasury, combined with debt lengthening by business, will mean only modest declines at best in long-term bond yields in 1982.

U.S. current-account prospects

Last year witnessed a significant deterioration in the rate of growth of U.S. exports. Following the 21% increase in U.S. exports (f.a.s., census basis) registered in 1980, exports grew at less than the rate of inflation last year—by roughly 7%. Looking ahead, growth in inflation-adjusted exports is not expected to show a major improvement until late in 1982. The import scenario is rather similar. After expanding by about 17% in 1980, imports slowed considerably in 1981 as U.S. economic activity trailed off in the second half of the year. This year, the sluggishness is expected to continue until midyear when import orders could climb sharply, depending on the strength of the U.S. recovery. With stable oil prices and economic weakness at home and abroad, the outlook is for only moderate deterioration in the U.S. trade and current-account positions in 1982.

The modest deterioration seen, however, will be cushioned by the fact that the U.S. current-account balance in 1981 is estimated to have chalked up a surplus of more than $7 billion. While the trade position weakened slightly in 1981, improved services earnings gave the United States a strong surplus on current account while most of its trading partners were suffering deficits stemming from the oil price shock of 1979.

The performance of the U.S. current account in 1982 will depend greatly upon the relative strengths of the industrial world's economies. Although the industrialized economies are regaining strength, there is no locomotive force seen leading the world out of its current slump. Thus, it is likely that economic developments—both positive and negative—will keep the U.S. current-account position from changing dramatically over the next 12 months.

Import prospects are for non-oil imports to continue flat or possibly decline in real terms through the first half of the year. They should pick up sharply in the second half, however, resulting in nominal growth of 8%-9% for 1982 as a whole. Coupling this performance with flat oil-import growth in nominal terms yields an overall increase in imports of around 7%, a rate roughly comparable with the inflation rate projected for 1982.

On the export side, non-agricultural exports are expected to grow by less than the rate of inflation during the first half of the year before tending to accelerate in the second half. A sustained resurgence in non-agricultural exports, however, will have to await an increase in worldwide economic activity, particularly European, if they are to grow at a rate comparable with their pace during the export booms of 1979 and 1980. Agricultural exports are forecast to rise by a modest 7%-10% this year, depending upon weather both at home and abroad. Improvement, nonetheless, is likely in the U.S. agricultural-export position. On balance, the 1982 outlook for U.S. exports is less than rosy. Exports will do well to stay ahead of the growth in world inflation.

Summing up, the U.S. trade deficit is projected to grow only slightly to a little over $30 billion in 1982 from $28 billion in 1981. The services account will again be called upon to offset the merchandise trade gap and should be sufficiently in surplus to do so. Such imponderables as the timing of business cycles in the United States and abroad, OPEC price shocks, and newly imposed barriers to trade, however, could swing the balance one way or the other by as much as $6-8 billion. But the most likely prospect is that the various influences cited above will yield a slight current-account surplus for the United States in 1982.

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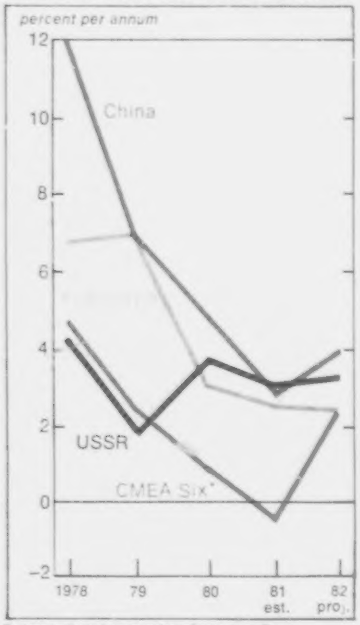
Protracted Austerity for the Centrally Planned Economies

As the OECD countries look toward a modest recovery in 1982, economic policy austerity will continue to dominate the centrally planned economies of Eastern Europe, the Soviet Union, and China. The shift from expansionary to restrictive policies in the Communist economies emerged as early as 1979 in Poland and Hungary, and slow growth and painful adjustment are likely to persist through the first half of the decade. The primary reasons for the growth slowdown include: rising relative prices for and inefficient utilization of energy and raw materials; poor agricultural performance, especially in Poland and the USSR; growing external debt burdens, aggravated by high real interest rates in the West and the strength of the U.S. dollar; and long-standing problems of labor productivity and social unrest, most conspicuous in Poland but haunting all Communist leaderships.

Communist governments have reacted with policy changes rather than organizational reforms. Investment spending and machinery imports have been cut, government expenditures and real personal incomes have been reduced, and domestic price levels have been boosted. The real-income decline has been most dramatic in Poland—which has witnessed a drop of about 25% since 1978—but Czechoslovakia, Hungary, and Yugoslavia have also seen significant income erosions. Many growth targets in the new five-year plans (through 1985) have been revised downward, and little growth is projected for capital investment during the period.

Reflecting the sustained austerity, the aggregate hard-currency trade deficit of the centrally planned economies has not deteriorated since 1978, although individual country balances have changed. Restrictions on nongrain imports, as well as fuel-export revenues earned by the Soviet Union and China, have contained the aggregate external deficit. The chief exception to this trend, however, has been the USSR; its trade balance swung into deficit by $4-5 billion in 1981. The shortfall absorbed half the USSR's foreign-exchange reserves held in Western banks and prompted increased Soviet gold sales. As for the East European Six, their diminished demands for credit from the West reduced their net liabilities to Western banks by $2 billion in the first half of 1981. Faced with resistance, Poland began to reschedule its debt, while Romania delayed its payments to foreign firms and borrowed from the IMF. China and Yugoslavia relied more heavily on the multilateral agencies, seeking larger assistance from both the World Bank and the IMF.

National income growth of Communist economies



* Poland, Czechoslovakia, Bulgaria, East Germany, Hungary, Romania

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Anemic growth with easing inflation seen for Canada.

The pace of Canadian economic activity is expected to be slow or stagnant at least through June, continuing the decline that set in during the third quarter of last year. The sluggishness is mainly the result of the U.S. recession. But it is being reinforced by fiscal and monetary policies that have remained restrictive to reduce an inflation rate that reached 12.5% in 1981. If the U.S. economy rebounds in the latter half of 1982, Canadian growth should also accelerate gradually. Nonetheless, 1982 GDP growth forecasts call for a 1% advance at best. The lessened demand pressures, however, along with lower food and interest costs, should permit substantial reductions in Canada's inflation rate over the course of the year—perhaps to the 10% range.

Consumer spending and exports fuel French recovery.

Data now confirm a pick-up in French economic activity beginning in the second quarter of 1981. Real GDP was up at a 2.4% annual clip in the third quarter, following 5.2% annual growth in the second quarter. The recovery reflects increased consumer spending and export strength, and is being fed by an expansionary fiscal and monetary policy. Real GDP growth in 1982 is likely to be about 3% on a year-average basis, following 0.5% growth in 1981. Inflation, however, is persistently high, and the balance-of-payments deficit continues to grow. The current-account deficit for 1981 is likely to have changed little from the 30-billion-franc deficit recorded in 1980. It may widen to more than 50 billion francs this year. And inflation is unlikely to recede much from its current level of 14%. Inflation and balance-of-payments difficulties will place the franc under downward pressure within the European Monetary System, which will intensify if the German mark recovers strongly in the first half of 1982 as many expect. Franc interest rates may then have to rise to quell speculation prior to any EMS realignment.

Belgium's new government acts to reduce fiscal and external deficits.

The new center-right coalition government of Wilfried Martens won a vote of confidence in Parliament, and will initiate measures to correct Belgium's economic imbalances. The government will seek to modify the country's system of wage indexation to achieve a 3% cut in real incomes and limit the 1982 budget deficit to 200 billion Belgian francs, instead of the 327 billion francs now foreseen. Both measures are needed to correct the country's growing imbalances: a current-account deficit of over $6 billion (more than 5% of GNP) and a public-sector deficit expected to reach 16% of GNP this year on unchanged policies. The foreign-exchange markets have reacted favorably to the new government. However, a successful loosening of wage indexation would give the authorities even more freedom to adjust the exchange rate, as higher import prices would no longer necessarily lead to higher wages.

Philippine economic weakness expected to continue.

The year just past appears to have been the poorest in some time for the Philippine economy. Although the government has not yet revised its mid-year estimate of 5% growth in real output for 1981, sectoral data suggest that projection is highly optimistic. Manufacturing output in the first half was off by 7%, and imports, except for oil, were well down in volume terms from 1980. Energy consumption declined. And about two-thirds of large Philippine firms surveyed were reported running in the red. The 1982 growth outlook is for continued weakness, although some improvement is likely. Given the prospective sluggishness of the industrialized economies, only moderate increases in export prices or volumes can be expected. With private investment demand continuing depressed, the government is moving toward a more expansionary fiscal policy. Its room for maneuver, however, is sharply limited by a current-account deficit estimated at $2.8 billion in 1981, up from $2.0 billion in 1980. Although a significant part of that increase reflected a rise in oil inventories likely to be reversed this year, the 1982 current-account shortfall could well be even larger.

Modest recovery seen for Spain's economy, but unemployment will continue rising.

The Spanish economy remains depressed, and the unemployment level continues to climb. There is, however, some indication that the bottom of the recession has been reached and that a modest upturn may have commenced in the second half of 1981. Exports of goods and tourism have recovered despite still-deteriorating Spanish competitiveness within Europe. Also, public-sector investment has been strong, as it is an integral part of the government's stimulatory fiscal package. The current year is expected to see some further improvement, largely on the heels of the recovery anticipated for the rest of Europe. It is also expected that wage and price inflation will moderate and that Spain's current-account deficit will narrow slightly to about $4.5 billion. Nonetheless, such a performance is unlikely to be sufficient to prevent unemployment from reaching the 2-million mark, or 18% of the labor force.

Japanese measures to spur imports will not prevent trade surplus growth.

With an overall trade surplus of about $21 billion, as well as large bilateral trade surpluses with the United States and the European Community last year, Japan is under intense pressure to restrain its exports and boost imports. Last December, the Bank of Japan cut its discount rate 75 basis points to spur domestic economic activity and, consequently, import demand. In addition, the government has announced a variety of import-related measures. It will extend $500 million in foreign-currency loans to finance special import purchases; authorize the emergency import of rare metals, together with the stockpiling of an additional 9.4 million barrels of oil; review quotas and other restrictions on such imports as oranges and beef; and ease product-testing procedures. The government is also accelerating by two years the stage-by-stage reduction of tariffs agreed upon in the Tokyo Round, implementing the scheduled cuts for fiscal 1982 through 1984 at one stroke in April 1982. Despite these measures, however, import growth is expected to remain modest in 1982 so that even with an export slowdown, Japan's trade surplus is expected to expand.

Brazil hoping for sustained external-payments improvement.

The Brazilian government is hoping to see the improvement in its balance of payments in 1981 carry through to 1982. The merchandise trade accounts last year shifted into a substantial $1.2-billion surplus from a $2.8-billion deficit in the previous year. As a result, the current-account deficit narrowed to $10.6 billion from almost $13 billion in 1980. The government sees export strength as the key to further improvement, since the import decline of last year is not likely to be repeated as economic growth accelerates. Priorities are being placed on industrial and agricultural exports in order to produce a trade surplus in the $3-4-billion range. If interest costs do not accelerate—a possibility in view of declining world interest rates—Brazil could post a further decline in its current-account deficit to $10 billion or less. Attainment of a smaller deficit, in turn, would reduce further Brazil's borrowing needs in 1982-83.

Iranian export earnings rebounding.

Iran's financial position deteriorated steadily over the course of 1981. While the war with Iraq contributed to the worsening, it was more the result of weak demand for Iranian oil, which until November was priced at $5 per barrel above Saudi marker crude. Prior to the November OPEC price realignment, exports had fallen to as low as 450,000 barrels per day, although revenue needs required a level of about 1.3 million barrels daily. Foreign-exchange reserves had fallen below $3 billion, and measures were taken to limit imports. In November, Iranian oil prices were reduced by $2.40 per barrel, and the differential with Saudi marker crude fell to only $0.60. Buyers have consequently returned, and latest reports indicate oil exports in the range of 900,000 barrels daily. Although this will not be sufficient to finance all of Iran's desired imports, it represents a substantial improvement in the country's financial position.

Surprise Money Surge Shifts Expectations

The recent surge in money growth caught the financial markets by surprise. While most forecasters had expected money growth to be relatively moderate in November and December, M1 (formerly M1-B) expanded at a seasonally adjusted annual rate of 12%. This unexpectedly rapid growth has been a major force behind the recent rise in interest rates.

Forecasters have been hard-pressed to explain the recent behavior of the money stock. It had been thought that the apparently steep decline in economic activity in the last two months, combined with a decline in the inflation rate, would keep money growth relatively weak by depressing the transactions demand for money. To be sure, it was anticipated that this effect might be offset somewhat by the easing in Federal Reserve policy and the concomitant sharp decline in interest rates that occurred in the fall. Such rate declines generally increase the demand for money relative to other assets. It is highly unlikely, however, that such a "rate effect" can explain the rapid growth of money in recent months.

While the money surge may be difficult to explain, its effect on interest rates is clear. Since late November, the rate on 90-day large, negotiable bank certificates of deposit has risen about 200 basis points and the yield on 30-year Treasury bonds has risen over 150 basis points.

To a large extent, these rate responses reflect changes in expectations regarding the effect of Federal Reserve policy on money-market rates. Specifically, since money growth has recently exceeded both expectations and the probable short-run targets of the Fed, the probability has increased that Federal Reserve open market tactics will put upward pressure on the federal funds rate.

A further expectational element may also be at work, however. This element concerns the information that recent rapid money growth may be conveying about the current or near-term future course of the economy and total spending. Monetary data are more timely than data on the performance of the economy, and are sometimes considered an indicator of total spending. Thus, the unexpected surge in money growth may suggest that total spending is either not as weak—or will not be as weak in coming months—as most forecasters had previously anticipated. This in turn would imply that expectations of future private credit demands and inflation may have increased.

Of course, the reliability of money growth as an indicator of total spending, especially in the short run, is distressingly poor. Nonetheless, the possibility—however slight—that recent money growth does imply greater strength in total spending has reinforced expectations of a near-term rise in interest rates.

Prospects Dim for Housing Recovery

The housing sector has perhaps borne the worst brunt of the restrictive Federal Reserve policy of the last two years. New housing units are currently being started at a rate 50% less than in the summer of 1979, and resale activity of older houses is down also by about 50%.

The apparent severity of housing's current problems is partly the result of comparison with the housing sector's boom years in the late 1970s. During 1966-75, an average of 1.6 million housing units per year were built, and turnover of existing homes averaged two million per year. In contrast, an average of 1.7 million units per year were built during 1976-80, with resales averaging 3.4 million.

Price behavior between these two time periods was also quite different. Housing prices rose by an average of about 6% during 1966-75, only slightly faster than the 5½% average rate of increase in the Consumer Price Index. But as inflation accelerated to nearly 9% in the latter half of the 1970s, heightening the investment and tax-saving benefits of home ownership, housing prices spurted by an average of 12% per year —three percentage points higher than inflation.

This rush into housing as an investment vehicle at a time when many other investments were failing to keep pace with inflation was aided by easier financing. Mortgage interest rates averaged only one percentage point above the rate of inflation during 1976-80, compared with two percentage points in the earlier period. And there was a marked trend over the fifteen-year period toward easier terms, i.e., longer-maturity mortgages and smaller down payments.

These trends began to reverse in 1980, with the reversal accelerating in 1981. The mortgage rate averaged about 14.75% in 1981, while the CPI rose only 10%; terms also tightened, especially with the shift toward shorter mortgages. Consequently, house prices increased by 6% last year, much less than the CPI; new housing construction barely topped one million units; and sales of existing homes totaled only a little over 2¼ million. Furthermore, activity slowed dramatically in the South and West, regions that had previously been less vulnerable.

As 1981 drew to a close, however, the rate of decline in housing activity slowed even as mortgage rates continued to rise. In December, mortgage rates actually declined somewhat, giving rise to hopes that a recovery would soon be under way. Any significant housing recovery, however, will depend upon sustained decreases in interest rates, since in a period of softening prices, lenders' other terms can be expected to remain restrictive. But as long as Federal Reserve policy continues explicitly disinflationary—resulting in interest rates several percentage points above the inflation rate—a return to upward spiraling house prices is remote.

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
			6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes latest data	12-month changes consumer prices	12-month changes latest data	12-month changes money supply(M1)	exchange rate in U.S. dollars January 13, 1982	change from year earlier January 13, 1982	current monetary conditions	
Africa	Algeria	Public-sector investment target for 1982 is $22 billion, up 35% from 1981.	Oct.	− 21%	29.0*	1,525	Nov.	3,839	+ 6%	4.7	0	Agreement reached with France on LNG export price.	Dec. '79	+12%	July	+17%	.2320	− 9%	European Investment Bank may lend $55 million.	Algeria
	Egypt	New government reassessing economy prior to setting development goals.	June	+ 30%	22.7	535	Sept.	1,171	+ 5%	2.4	102	Suez Canal tolls up 5%; oil find in Suez Gulf proves commercial.	May	+10%	Sept.	+11%	1.23	14%	Money supply expanding steadily.	Egypt
	Ivory Coast	World Bank approves $150-million structural adjustment loan to revitalize economy.	Apr.	+ 1%	10.5	1,312	Sept.	8	−59%	0.1	325	Five Espoir field exploratory wells yield mainly gas, rather than oil.	May	+11%	Apr.	+ 4%	.003436	−16%	Liquidity shortage persists.	Ivory Coast
	Kenya	Producer prices raised for maize and wheat.	June	− 12%	6.8	414	Nov.	264	−47%	1.5	207	September devaluation curbing import growth.	Sept.	+12%	July	− 1%	.1110	−21%	Monetary policy continues highly restrictive.	Kenya
	Madagascar	Joint ventures with Libya to be set up in agriculture, livestock, fishing, and shipping.	Dec.	+ 5%	3.0	345	Dec.	0	---	0	88	French credits of $73 million will finance badly needed imports.	May	+39%	n. a.	—	.003506	−14%	Malagasy banks out of foreign exchange.	Madagascar
	Malawi	Export-led recovery estimated to have lifted 1981 real GDP growth to 4.8%.	Aug.	+ 17%	1.5	250	Nov.	69	−12%	2.6	89	High tobacco prices boost export receipts and close trade gap.	Aug.	+ 7%	Oct.	+11%	1.1150	− 6%	Credit to government expands sharply.	Malawi
	Morocco	Economy adversely affected by second consecutive year of drought.	July	− 9%	18.1	896	Oct.	182	−11%	0.5	458	Current-account gap estimated at $1.8 billion in 1981, vs. $1.4 billion in 1980.	Aug.	+15%	Aug.	+10%	.1900	−21%	State phosphate company raises $175-million Eurocredit.	Morocco
	Nigeria	Reduced allocations to states cause cuts in project outlays.	Oct.	− 45%	78.0	1,013	Oct.	5,217	−49%	3.3	0	Oil price cuts of $0.30-$1.45 per barrel effective January 1.	Dec. '80	+14%	Apr.	+29%	1.5755	−18%	Seven new banks to be run by state governments.	Nigeria
	Senegal	Construction begun on $300-million phosphatic fertilizer project.	Dec.	− 9%	2.5	437	Sept.	4	−62%	0	142	Forecast doubling of groundnut crop should bolster 1982 payments balance.	Aug.	+ 8%	Mar.	− 2%	.003436	−23%	Liquidity tightness continues.	Senegal
	South Africa	Hike in general sales tax or reimposition of loan levy expected in March budget.	Oct.	− 22%	76.9	2,627	Nov.	677	−33%	0.4	0	Premiums on forward dollars discourage offshore trade financing.	Oct.	+15%	July	+37%	1.0370	−21%	Further monetary tightening probable.	South Africa
	Sudan	Devaluation and other incentives should spur cotton production.	July	+ 32%	9.0	482	Nov.	31	−63%	0.2	480	Current-account gaps in '81 and '82 near $800 mn., requiring external aid.	May	+27%	Sept.	+41%	1.1275	−44%	Inflationary pressures increase.	Sudan
	Tunisia	Public-sector capital budget for 1982 is $1.3 billion, 16% larger than last year.	Sept.	0	8.6	1,350	Nov.	661	− 4%	1.9	0	Two significant oil discoveries made recently.	Sept.	+10%	Aug.	+24%	2.02	−18%	Local banks expected to finance more investment.	Tunisia
	Zimbabwe	Wage hikes and temporary price freezes squeeze many businesses.	Dec.	− 5%	4.8	645	Aug.	220	−30%	1.7	86	Reopened Beira-Umtali pipeline ends need of S. Africa for fuel transport.	Dec.	+20%	Dec.	+16%	1.45	0	Liquidity severely tightened.	Zimbabwe
Middle East	Jordan	Record government 1982 budget of $2.2 billion approved, up 16.6% from last year.	Feb.	+148%	3.6	1,127	Nov.	1,166	−10%	6.1	0	Phosphate export revenues holding steady.	Sept.	+19%	Aug.	+27%	3.00	− 4%	Saudi Development Fund to lend $47 million.	Jordan
	Kuwait	Kuwait Petroleum Company to step up overseas oil exploration activity.	Oct.	− 9%	27.3	19,870	Nov.	3,732†	− 6%	7.0	0	Project awarded to Japanese firm to tap neutral zone gas now flared.	Dec. '80	+ 8%	Sept.	+28%	3.5350	− 4%	Indian firm makes record $107-mn. private bond placement.	Kuwait
	Qatar	Budget expenditure target for 1982 cut nearly 7% from 1981 allocation of $2.5 billion.	Oct.	− 9%	5.0	23,100	Sept.	347†	−10%	3.2	0	Oil price cut $0.20 per barrel to $35.30-$35.45.	n. a.	—	Sept.	+17%	.2775	+ 1%	Bank claims on private sector growing rapidly.	Qatar
	Saudi Arabia	Actual government spending in fiscal 1980-81 was $62 billion, up 13% from year earlier.	Oct.	+ 15%	117.6	19,500	Nov.	31,549†	+28%	12.4	0	Oil production ceiling cut to 8.5 million barrels per day.	June	+ 2%	July	+17%	.2935	− 2%	Money supply growing steadily.	Saudi Arabia
	United Arab Emirates	Abu Dhabi plans increase in oil output capacity to 3 million barrels daily by 1985.	Oct.	− 3%	19.4	23,000	Nov.	3,094†	+59%	4.3	0	UAE oil output was 1.4 million bpd in 1981, down 15% from 1980.	n. a.	—	Sept.	+ 8%	.2750	+ 1%	Credit to private sector continues to increase.	United Arab Emirates

*1979

†Excluding state reserves

World Interest Rates

market rates of Jan. 13, 1982; bond yields as of Jan. 8, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	14.74	14.406 intervention rate	14.00	9.00	7.50	19.00 penalty rate 22.00	9.00	6.00	5.50
Day-to-Day Money	12.75 January 14	14.25	14.75*	11.95	15.50	10.20	20.375	10.25	5.125	6.5625
Treasury Bills 91-day, Middle Rates	12.08 discount basis	14.45	14.625*	15.00	16.18 one year	n. a.	19.401 90-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	12.00 finance paper discount basis	15.20 finance paper 15% tax w/h	13.794*	13.90 Certified	15.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	12.70	15.05 15% tax w/h	14.75*	13.90 Certified	not traded	9.90	23.70	no market	9.125	no market
Government Bonds Long-term, new and old issues, average yield	14.61	16.812	15.37	11.46 20% tax w/h	15.99	9.78	21.01	11.22	5.35	7.462
Industrial Bonds prime, long-term, new and old issues, average yield	15.60 Aa Industrials	16.32	16.61	16.425	17.31	9.95	20.78	12.49	6.3125	7.15
Bank Short-Term Rate to Best Borrowers (prime rate)	15.75	16.50	15.50*	17.50	16.85	15.50	22.50 ½ quar'ly fee on outstdng.	12.50	9.75	6.00
Bank Time Deposits 3-month	12.75 Cert. of Dep.	15.00	15.50*	14.75	15.375	10.35	10.75	10.875 large deposits	8.00 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	14.3125	no market	15.5625	no market	16.75	10.50	no market	10.875	8.8125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8392	1.8675	.0257	.1712	.4345	.000813	.3986	.5365	.00446
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.20 *D*	1.075 *D*	6.586 *D*	2.316 *D*	3.648 *P*	7.824 *D*	3.298 *P*	5.322 *P*	7.854 *P*

Eurodollar Deposits

(London, interbank, bid)

January 14

7-day	13.0625
1-month	13.5625
3-month	14.125
6-month	14.9375

International Arbitrage

(3-month, hedged) ✚ *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	n. a.
U.S.-Canada Treasury Bills	− .478
U.S.-Canada Finance Co. Paper	−1.791
Eurodollars-U.K. Local Auth. Deposits	n.a.

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.75
Over 7 yrs.	16.00
DM Bonds	
7 yrs. and under	9.75
Over 7 yrs.	9.75

Gold Price

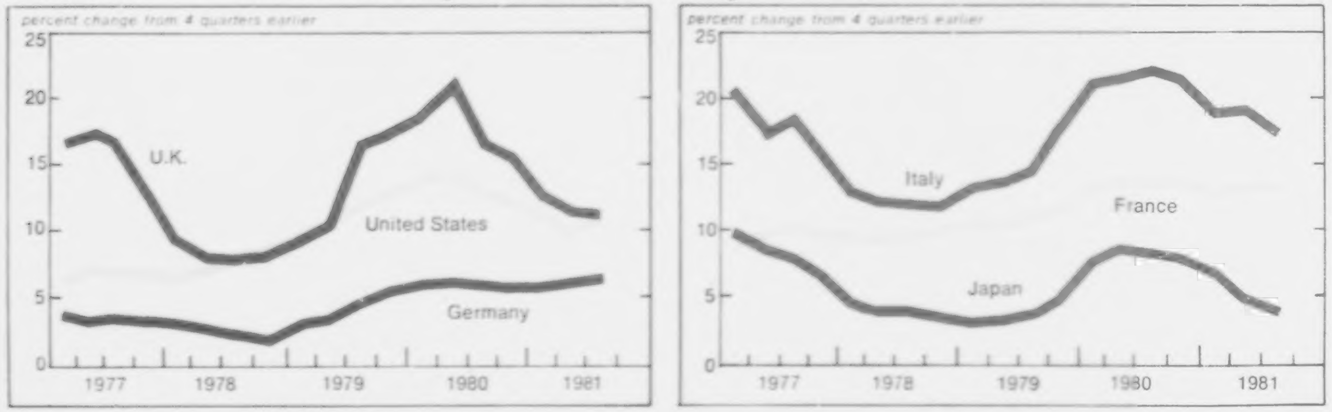
London
afternoon fixing

380.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of Jan. 6, 1982.

Consumer price trends in major industrial countries



Chinese Readjustment to Continue

After two years of stabilization policies and tentative economic reforms that reduced national income growth to an average 6% in 1979-80 from over 12% in 1978, China's budgetary authorities proceeded to adopt highly restrictive policies at the start of 1981. And Chinese policymakers have recently ratified a plan that will maintain the austere stance of fiscal and monetary policy in 1982.

The impact of the austerity measures in 1981 was most dramatic in heavy industry and capital construction, where annual production fell below 1980 levels. Indeed, midway in 1981, heavy industrial output was nearly 10% below the year-earlier period; a modest recovery in the second half moderated the fall, bringing annual production to about 4½% below 1980.

The decline in China's heavy industry last year was concentrated in marginal enterprises, particularly the smaller coal mines and metallurgical plants. Given their antiquated technologies, these plants have long operated at economic losses simply to boost gross output figures and employment. And because of China's irrational price structure, the extent of such operating subsidies was often unknown by central planners.

Spending on capital construction in 1981 fell to 25% below that of 1980 as construction organizations were directed to complete unfinished projects rather than begin new ones. One of the major objectives of the austerity program has been to establish greater control over construction authorized by provinces and municipalities. Even though progress was made, total investment in capital construction will probably exceed 40 billion yuan[1] in 1981. One major construction project that may win approval in 1982 is a nuclear power plant. It would be China's first, and would be located in Guangdong Province near Hong Kong, where projected electricity demands are expected to far outstrip generation capacity.

The shift of resources away from heavy industry did contribute to bottlenecks for certain key materials as well as budgetary hardships in some regions last year. Still, the growth of light industry and agriculture remained strong and more than offset the declines in other sectors. Indeed, output of light industry and textiles rose 14% in 1981, after an increase of 18% in 1980. This sustained 9% growth in the volume of retail sales of consumer goods and 10% growth in exports measured in current dollars.

Despite problems with flooding and drought in the early summer of 1981, total grain production for the year is estimated at 325-330 million metric tons—only slightly below the 1979 record harvest. Estimates of total agricultural production show a 2½% rise above the 1980 level, with cotton, sugar, and oil seeds posting the strongest gains. Growth in the livestock sector, however, slowed from the rapid pace achieved in 1979-80. All in all, national income growth last year is estimated at just 3%.

Inflation and government spending

Various austerity measures to limit wage increases, maintain state employment levels, and reduce public spending helped ease domestic inflationary pressures last year. Significantly, the state budget deficit was cut to 2.7 billion yuan, equal to only one-fifth the 1980 deficit.

State Budget *(billion yuan)*	1979	1980	1981 *prelim.*	1982 *proj.*
Total Revenue	110.3	108.52	105.86	110
Total Expenditure	127.3	121.27	108.58	113
Balance	−17.0	−12.75	−2.72	−3

The most rapidly growing component of government expenditure has been outlays for consumer subsidies, which rose 50% in 1981 to 32 billion yuan. Prices for tobacco and liquor were raised nearly 40% at the end of 1981 to offset partially these subsidies paid for grains, cooking oil, meat, dairy products, and vegetables—which primarily benefited urban consumers.

Actual inflation rates in China are difficult to estimate, but the official data will probably show an increase in retail prices of only 3%-4% in 1981, an improvement over the 6% rate recorded in both 1979 and 1980. Part of this improvement can be traced to official efforts to contain monetary growth. To help absorb excess money balances, the government sold 4.67 billion yuan in treasury bonds (paying 4% interest over 10 years) in the first half of the year. And after explosive growth of some 25% annually during 1979-80, the money supply actually declined in 1981 by 5%-10%.

Impact on external position

The direction of the effect such domestic austerity will have on China's foreign trade is clear, but the extent of the shift toward balance remains uncertain. In the first half of 1981, China's imports grew more rapidly than its exports. Data through September released by the Ministry of Foreign Trade indicate, however, that imports fell sharply in the summer and that China recorded a trade surplus of $1 billion in the third quarter.

Imports of machinery were down significantly in the first nine months of 1981, but they are likely to increase once again in the wake of agreements signed with Japan. Grain imports were high in the first half of the year, but dropped off significantly in the second

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[1] *1.71 yuan = U.S. $1, estimated average exchange rate for 1981.*

Chinese Readjustment to Continue

(continued from page 7)

half. China has signed several bilateral agreements to cover annual imports of 12-17 million metric tons of grains to supply coastal regions. Japanese steel shipments are also expected to increase this winter, particularly with construction work planned for transporting coal to Beijing and northern ports. Taking into account all of these influences, China's trade deficit with the member nations of the International Monetary Fund is estimated to have been $1.0-1.5 billion in 1981, compared with a $2.2-billion deficit in 1980.

At the end of 1981, Finance Minister Wang Bingquian estimated that China's external liabilities had reached $4.7 billion, up from $3.4 billion at end-1980. (This figure probably does not include liabilities in certain joint ventures and provincial compensation agreements.) During the year, China received its first World Bank loan of $200 million for educational projects, and several other major project loans are anticipated for early 1982. China will probably draw another 450-million SDR tranche from the IMF in 1982, which will boost its total drawings from multilateral sources to $1.5 billion. As of mid-1981, China's foreign-exchange reserves had risen to $3.[illegible] billion (a surge of $1.5 billion in six months). Reserves were unchanged at the end of the third quarter despite the large trade surplus; they are expected to have declined to around $3 billion by yearend as various commercial loans drawn in the fourth quarter of 1980 were repaid.

China's other major source of foreign capital has been Japan. A 300-billion-yen loan has been negotiated to help finance the completion of the Baoshan steel complex and two petrochemical projects at Daqing and Nanjing that had been cancelled a year ago. Japan has also been providing annual loans of 50-60 billion yen for infrastructure development in China, and more than 200 billion yen has been granted for offshore oil exploration and development in the Bohai Gulf. Additionally, the Export-Import Bank of the United States has approved two major loans covering purchases from Westinghouse and Combustion Engineering. The total of U.S. official credits, however, still remains at less than $100 million.

Policy responses

During the past year, spokesmen for economic development and new projects have begun to stress the need for a new five-year plan and a shift of resources back to heavy industry and construction. The revival of the Japanese projects even prompted some Western observers to predict a major swing in economic policy back toward rapid growth. Instead, the National People's Congress has ratified a plan and budget for 1982 that will maintain fiscal and monetary austerity. Premier Zhao indicated that readjustment will continue for several more years while announcing that the five-year plan for 1981-85 is still being drafted. At the same time, he emphasized the importance of foreign trade for China's modernization, and supported the outflow of Chinese labor for construction projects abroad as well as the inflow of Western capital and technology.

The meeting of the National People's Congress in late 1981 produced a new tax law governing foreign operations in China. The law provides for a progressive rate structure ranging from 20%-40%, with a local surtax of 10%. It should preclude the incidence of double taxation for Western companies. However, the financial incentives given under the law are less generous than those provided multinational enterprises in other Asian countries. This may actually slow the growth of direct investment in China—with the significant exception of offshore oil development, which may require $5-10 billion of foreign capital before 1990.

Continuing the trend of recent years, China moved at the end of 1981 to reorganize and upgrade its banking system. The People's Bank announced an increase in interest rates paid to depositors and charged to borrowers. For transactions with maturities between one and five years, interest rates will range from 6.48% to 8.28% for overseas depositors and from 5.76% to 7.92% for domestic depositors. At the same time, the Ministry of Finance authorized the establishment of a new investment bank to raise foreign loans for joint ventures in China. This specialized institution will be controlled by the Ministry of Finance and the Bank of China, but will probably consist merely of a consolidation of existing offices that will remain within their old bureaucracies.

Outlook for 1982

The outlook, then, is for China's economic growth to remain modest in 1982, with national income growing at approximately the planned rate of 4%. Some recovery in heavy industrial production and capital investment is anticipated. Domestic investment will continue to emphasize infrastructure, drawing upon financing and expertise provided by the World Bank and foreign governments. And on the external front, China is expected to post a hard-currency trade deficit of approximately $2 billion.

China's new tax legislation should help stimulate offshore oil development in several promising areas. Given the magnitude of offshore petroleum investments and the delays anticipated in development, however, international oil companies and banks will be carefully assessing the political risks involved in direct investment. Still, the long-term outlook for China appears promising, particularly when contrasted with the slow growth seen for the other centrally planned economies in the 1980s.

Donald W. Green

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Unexpected Money Growth Prompts Dollar Strength

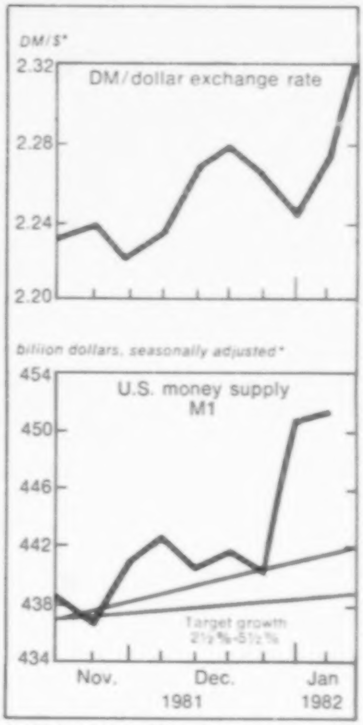
The foreign-exchange value of the dollar has risen sharply in recent weeks, in spite of the current weakness in the U.S. economy. The primary force behind this excess demand for dollars has been expectations. The unexpectedly rapid growth of the money supply (as measured by M1) has resulted in an increase in the market's perception of the likelihood that the Federal Reserve will tighten monetary policy.

This acceleration of the money supply was not fully anticipated by the market because monetary strength is unusual for an economy in a period of steep decline. Growth in the demand for M1 arises principally from growth in transactions demand, and transactions ease off, not accelerate, during recessionary periods. Further confounding the markets—and creating substantial uncertainty until these "mixed signals" are resolved—are the informational lags associated with data on real economic activity versus data on the money supply. However, since data on the real sector are reported with lags of up to two-to-three months, while monetary data are reported with lags of only two weeks, a critical question arises: Do the monetary data reflect a much quicker than expected turnaround in the U.S. real economy, or are they merely aberrations that will be reversed in the weeks ahead? The resolution of this issue poses opposite paths for the dollar's value.

If the rapid growth of the money supply represents incipient real economic strength, the foreign-exchange market expectations will be confirmed. The necessary tightening by the Fed to constrain money growth to within target limits may be severe, leading to significant excess dollar demand and dollar strength over the near term. Alternatively, if the recent growth in the money supply is merely due to temporary factors, and is reversed in the weeks ahead, then the dollar will weaken. Confirmation that real economic activity in the United States is continuing to decline would shift market perceptions from anticipated excess demand for dollars to an anticipated excess supply.

Thus, the quandary existing in foreign-exchange markets is similar to that facing U.S. domestic financial markets. The signals as to the near-term course of the real economy are not fully consistent, and the likely policy actions of the Fed in the short-run are still highly uncertain. The suspicion here is that the recent monetary growth has misled the market, and the current dollar strength will prove temporary. But when the turn-around will come is highly uncertain.

U.S. money growth and exchange rates



* weekly average of daily figures

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Germany's continued domestic weakness prompts lowering of Lombard rate.

Germany's economy is currently being sustained by exports, which rose at an annual rate of 24% in the third quarter. Domestic demand, however, remains depressed, with domestic order volume falling by some 6% since the beginning of 1981. The unemployment rate soared to 7.3% in December, from 4.8% at the end of 1980. This weakness in the domestic economy coincided with below-target growth in Germany's central bank money stock (CBM) and prompted the Bundesbank to reduce its special Lombard rate by one-half percentage point to 10%, despite a firming of U.S. interest rates. The Bundesbank's slight easing was taken in conjunction with similar moves in Britain and Holland. It may indicate that Europe's recession has reached a point where central banks are putting less emphasis on defending their currencies against a strong dollar, particularly if they perceive the firming of U.S. money market rates to be temporary.

Danish economy poised for recovery: policies likely to remain restrictive.

The Danish economy now seems to have weathered the worst of its problems and looks set to begin a long road to recovery. The new government, elected at the end of last year, is expected to continue with reasonably restrictive economic policies. And assuming that economic activity in most of Europe will generally perk up this year, current forecasts are projecting a modest 2% real growth for Denmark in 1982. The rate of inflation—which at 11% in 1981 was the highest in the European Monetary System—is expected to decelerate somewhat this year to around 9%. And a narrowing of the current-account balance-of-payments deficit also seems likely. According to budget plans announced earlier this month, however, there seems to be little scope for any reduction of the huge government deficit. The fiscal 1982 budget gap is now forecast at kr. 47.7 billion, which it is estimated would amount to some 10% of GNP—even higher than the 1981 deficit, which came to about 9.5% of GNP.

Chilean inflation dramatically lower as recession takes hold.

Weak international metal prices, the economic slowdown in the industrial countries, and a fixed exchange-rate policy for two-and-a-half years have combined to cloud Chile's economic prospects in the near future. Economic activity is slowing rapidly; real GDP is estimated to have risen approximately 5% in 1981, versus annual increases averaging 7% in the previous two years, and no growth is expected for 1982. In the external area, the current-account deficit has expanded to an estimated $4.3 billion in 1981 from $1.8 billion in 1980. But even without an exchange-rate adjustment, the current-account gap is not expected to widen much further in 1982. This is because copper prices are likely to rise moderately and import growth should begin to ease off, reflecting the recessionary economy. One bright consolation to the slackening is that inflation has dropped precipitously from 31% at the end of 1980 to 9% by end-1981. And if no exchange-rate correction is made, inflation can be expected to fall even lower in 1982.

Venezuela postpones stimulative policies in light of sluggish oil markets.

The reactivation of the Venezuelan economy that had been expected in 1981 did not occur, and the economy remained stagnant for the third consecutive year. Government authorities—not wanting to fuel aggregate demand at a time when the world oil market was experiencing a reversal—maintained a restrictive posture toward fiscal and monetary policy. Agricultural production suffered a setback because of adverse weather conditions in the early part of the year. In addition, Venezuela, along with several other OPEC members, reduced crude oil production by some 10% at midyear in an effort to firm oil prices. Venezuela's external sector continued to perform well, however, despite the moderation of oil prices and a drop in the volume of oil exports. The current-account surplus is estimated to have fallen only to about $3 billion in 1981 from $4.2 billion in 1980. The government's conservative demand-management policies and a hiatus in its price liberalization program did have a positive impact on inflation. With the help of lower import costs, owing to dollar strength in the first eight months of the year, the rate of inflation was held at 12% in 1981, according to official statistics—a significant improvement over price increases of 20% in both 1979 and 1980.

Year of economic adjustment ahead for Finland under new president.

Finnish economic statistics are converging towards the European average after three years in which the country consistently outperformed the rest of Europe. Real growth is expected to slow to some 1.8% this year. And the inflation rate is expected to slow to near 10%. The current-account balance-of-payments deficit is likely to widen to about $1 billion. The Finnish government, under its newly-elected President Koivisto, will clearly seek to use 1982 as a year of adjustment. With inflation falling and some degree of surplus industrial capacity, the country should be able to take advantage of an economic strengthening in Europe and move back to a higher growth path by 1983.

Signs emerge of shift in Korean policy, but constraints are strong.

South Korea's recent cabinet reshuffling may signal subtle changes in the country's economic policies. With real growth estimated at 7% in 1981, the economy did recover from the severe recession of 1980. However, the current-account deficit remains onerous—$4.7 billion last year—and although the inflation rate was reduced to about 13% last year from 28% in 1980, there is the danger of a reacceleration in inflation. Given the overriding concern about improving the balance of payments and price stability, the policy options of the new economic team are limited. A shift toward encouraging the private sector, however, may be in the offing. The new cabinet has lifted direct controls on bank credits, and appears ready to accept a gradual but realistic adjustment of the won's exchange rate. Interest rates have also been lowered. And measures have been taken to increase low-cost export financing and to provide a fiscal stimulus to housing. While these are not all necessarily "free-market" oriented, they reflect the government's desire to bolster business confidence, which was shattered in part by the failed industry-realignment effort early in the Chun regime.

Pakistan de-links rupee from dollar to enhance export competitiveness.

As another indication of its resolve to turn the economy around, the government of Pakistan announced on January 7 that the rupee would no longer be pegged to the dollar. Instead, the rupee's value would be linked to a trade-weighted basket of currencies of Pakistan's major trading partners. The rupee had been fixed at a rate of 9.9 rupees per dollar since 1973. However, with the rupee pegged to the dollar, the strong appreciation of the dollar during 1981 resulted in a serious loss of competitivenesss in Pakistani products. Pakistan's exports suffered as a result, increasing only 11.5% in July and August from the level a year earlier, compared with export growth of 16.3% for a comparable period in 1980. By adopting a basket policy, Pakistan's monetary officials will be able to insulate the value of the rupee from further sharp changes in the dollar's value. The dollar will still remain the intervention currency, but the central bank will set the rupee/dollar rate daily to achieve a desired behavior of the rupee against the basket, given the dollar's performance against other currencies.

Drought again threatening Moroccan grain harvest.

Morocco's current-account gap widened noticeably last year to $1.75 billion from $1.42 billion in 1980, according to preliminary estimates. The deterioration stemmed largely from a jump in the merchandise trade deficit to over $2 billion from $1.8 billion in the previous year. Imports, led by purchases of petroleum and foodstuffs, rose to $4.2 billion (on a c.i.f. basis). The increased food imports reflected not only larger purchases of grains—whose domestic output was cut 50% by the 1980-81 drought—but also the higher local currency costs of imports resulting from last year's 31% depreciation of the Moroccan dirham against the dollar. Dollar-denominated export revenues fell slightly, despite a sharp increase in receipts from phosphate exports. The trade deficit would have been even larger had it not been for continued growth in exports of "invisibles"—primarily worker's remittances and tourist income. The outlook for 1982 includes the risk of another sizable trade deficit. While major exports of goods and services are expected to expand, dry weather is once again threatening the Moroccan grain crop, raising the prospect of a second year of huge food imports.

Optimism on the Inflation Front

The rate of inflation moved back down into single digits in 1981. For the year, the Consumer Price Index (CPI) slowed to under 9%—down significantly from more than 12% in 1980 and over 13% in 1979. The outlook for 1982 suggests continued progress, with the CPI forecast to rise less than 7%. And prospects for 1983 are possibly even better.

The recent improvement in inflation, as well as increased optimism about the future, has come about largely because of a reversal in the forces underlying the double-digit inflation rates of 1979 and 1980. Excessive fiscal and monetary stimulus in earlier years exerted much of the upward price pressure. And the second oil price shock—touched off by the Iranian Revolution in 1979—combined with the dollar's rapid decline on the foreign-exchange markets in the late 1970s, added further to the inflationary stress.

Generally more restrictive Federal Reserve policy over the past two years has laid the groundwork for a sustained deceleration of inflation in 1982. The change in the Fed's operating strategy in October 1979 resulted in lower average growth in the money supply. Growth in M1 (formerly M1-B) slowed from 7½% in 1979 to 6½% in 1980 and 5% in 1981. In addition, the rate of increase of federal expenditures is now decelerating markedly. World oil prices have been relatively stable and are likely to remain so for at least this year. Weak domestic demand has held down the prices of final petroleum products even more. Furthermore, the foreign-exchange value of the dollar has strengthened significantly.

Perhaps most important to future price prospects, however, is that falling actual inflation is helping to lower expectations about future inflation. Although the skepticism of many financial-market participants about the Fed's ability to adhere to its policy of lowering money growth is currently keeping real interest rates high, other market participants are adjusting their expectations more quickly. Farmers and other commodity producers, for example, are being forced to accept outright price declines because of weak final demand and high real carrying costs.

And in the labor market, evidence of a willingness to accept smaller wage increases—particularly in the non-unionized sectors—is becoming more prevalent. The hourly earnings index grew at an annual rate of about 8% in December, down from 10% in early 1981. Moreover, the fact that some of the large unions are bargaining this year in an environment of slowing inflation and high—if not rising—unemployment would suggest that average wage gains may narrow even more. This should ease unemployment, and give the Fed a bit of political breathing room, improving the likelihood of its staying with a disinflationary policy.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1980		BALAN			
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered
Austria	Selective reflationary measures are now under discussion as growth prospects weaken.	Mar.	+1%	76.5	+3.1%	Nov.	4,590	– 5%	2.7
Belgium	New government obtains special powers to deal with growing fiscal deficit and wage indexation.	Oct.	–1%	118.7	+2.0%	Nov.	5,306	–34%	1.0
Britain	Economic upturn at end of 1981; output growth forecast in 1982, after two years of decline.	Nov.	+1%	524.6	–1.4%	Nov.	15,570	–27%	2.0
Denmark	Revival of economy expected over the course of 1982.	Oct.	–8%	64.7	–0.2%	Nov.	2,678	–18%	2.0
Finland	Economic growth continues to slow.	Oct.	+3%	51.0	+6.0%	Nov.	1,390	–27%	1.2
France	Despite strong consumer goods sector, intermediate and capital goods sectors remain flat.	Oct.	–2%	651.1	+1.2%	Nov.	21,837	–24%	2.3
Germany	Economy remains weak; limited fiscal reflation under consideration.	Nov.	0	822.2	+1.8%	Nov.	44,582	– 7%	3.4
Greece	Reflationary budget expected in February as economy continues in recession.	n. a.	—	61.1	–0.7%	Nov.	1,352	+17%	1.9
Ireland	Strongly restrictive budget is expected at end of January.	Aug.	+1%	17.6	+1.9%	Nov.	2,702	+ 7%	3.1
Italy	Domestic economy remains weak but inflation moderates; 1% real growth expected in 1982.	Nov.	0	394.9	+4.0%	Nov.	18,559	–19%	2.4
Netherlands	Special employment-creating program instituted, but authorities impose another year of incomes policy.	Oct.	0	159.9	+1.0%	Nov.	9,259	–19%	1.7
Norway	Economic activity apparently picking up slowly.	Oct.	–3%	55.4	+3.6%	Nov.	6,463	+ 5%	5.3
Portugal	Economic growth in 1981 unlikely to have reached official target of 2.9%	Mar.	–2%	23.5	+5.5%	Oct.	616	–44%	0.8
Spain	Hopes of export-led recovery emerging.	Dec. '80	+5%	195.9	+1.5%	Oct.	11,360	– 8%	4.3
Sweden	GDP is expected to show almost no growth in 1982, following 1.2% decline last year.	Sept.	–6%	121.6	+1.4%	Nov.	3,578	+ 3%	1.6
Switzerland	Business outlook deteriorating; real GDP decline likely in 1982.	June	0	105.8	+3.9%	Nov.	10,429	–18%	4.1
Canada	Economy slowing down, with higher unemployment and weaker industrial activity.	Oct.	–2%	247.9	0	Nov.	3,702	+46%	0.6
United States	Inventory liquidation leads to continued cutbacks in production.	Dec.	–5%	2,626.1	–0.2%	Nov.	19,850	+37%	0.9

Business Credit Demand to Stay Strong

Sharp cutbacks of business inventories are accompanying the continued weakness in the economy. As a result, many observers anticipate that bank loan growth will slacken, taking some pressure off short-term interest rates. Recent evidence, however, seems to conflict with this view.

Over the fourth quarter of last year, for instance, total business loans rose at a 13% annual rate. And the usual January correction, offsetting loans made for end-of-year balance-sheet adjustments, was abnormally low. This stronger-than-expected loan demand currently may stem from poor business sales performance and further undesired inventory accumulations. But there are several other forces that may also sustain this pattern for the next few months, despite soft economic conditions.

One possible source may be depressed corporate cash flow, which, by reducing available internally-generated funds, can induce greater reliance on outside borrowing. For example, many smaller firms that are having difficulty meeting their interest obligations may be borrowing to capitalize interest payments. As a result, these firms will increase their level of borrowing each time they roll over existing loans. This phenomenon will lead to an acceleration of loan demand, which will persist until business sales and earnings recover, enabling these firms to become more solvent.

Another source of increased demand has been borrowing to finance acquisitions. While these loans are sporadic and of a temporary nature, a depressed economy contributes to the circumstances that make takeovers more likely. Because stock prices tend to reflect investors' expectations of future corporate earnings, they are more likely to be depressed now, and the market value of many firms' productive assets can consequently fall below their replacement value. As a result, more successful firms may find that acquisitions are a cost-effective means of new investment.

The greater-than-expected strength of short-term credit demand also reflects the unattractiveness of the long-term bond market as an alternative source of funds. The rebound in long-term interest rates, indicative of the market's continued nervousness about future inflation and bond price volatility, has tended to prolong reliance on short-term credit. In addition, the number of downgradings by rating agencies has increased dramatically in recent weeks. Questions about credit quality raised by these actions will also tend to curtail the issuance of long-term debt. Indeed, both of these developments are already being reflected in current market activity: Despite the heavy January forward calendar, practically no new bond issues have actually been brought to the market. Without an improvement in long-term rates or in the credit quality of issuing corporations, it is unlikely that the bond market can serve as a vehicle for reducing the borrowing pressure that is now concentrated in short-term maturities.

CE OF PAYMENTS		MONEY AND BANKING							COUNTRIES
use of IMF redit, mil- ns of dollars	current influences on payments	12-month changes				central bank rate	exchange rate in U.S. dollars	current monetary conditions	
		latest data	consumer prices	latest data	money supply(M1)	January 27, 1982			
0	Current-account deficit down through Sept. 1981; export orders strong.	Nov.	+ 7%	Sept.	− 1%	6.75%	.0623	Interest rates continue to move in tandem with German rates.	**Austria**
0	Export prospects poor in view of overvalued franc.	Dec.	+ 8%	June	+ 7%	14.00%	.0254	Rates ease as pressure on franc subsides.	**Belgium**
369	All time record current-account surplus estimated for 1981.	Dec.	+12%	Sept.	+12%	13.937%	1.8680	High level of real rates suggests imminent declines.	**Britain**
0	1981 Jan.-Sept. current-account deficit was kr. 8 billion, vs. '80's kr. 11.4 bn.	Oct.	+12%	July	+14%	11.00%	.1311	Current-account deficit forcing tight monetary policy.	**Denmark**
67	Jan.-Nov. 1981 trade deficit was fmk. 1.7 million vs. fmk. 5.5 million year ago.	Nov.	+10%	July	+ 7%	9.25%	.2240	Stable exchange rate allows policy to remain restrictive.	**Finland**
0	Heavy trade deficit in latter 1981 will widen further over next six months.	Dec.	+14%	Aug.	+12%	9.50%	.1691	Stable Franc in EMS permits lowering of domestic rates.	**France**
0	Exports and export orders rise briskly; current account now back in surplus.	Dec.	+ 6%	Sept.	− 1%	7.50%	.4300	Lombard rate reduced by ½ point, despite strong dollar.	**Germany**
1,349	Private capital inflows slow down in second half of 1981.	Oct.	+31%	n. a.	—	20.50%	.0185	Credit policies set to ease.	**Greece**
0	Jan.-Nov. trade deficit in 1981 was £1.7 billion vs. £1.2 billion year earlier.	Aug.	+20%	Oct.	+ 6%	16.50%	1.5250	Commercial banks' required liquidity ratios raised.	**Ireland**
0	Export prospects brighten; current-account deficit to fall markedly in 1982.	Dec.	+18%	Aug.	+ 9%	19.00%	.000803	Money remains tight.	**Italy**
0	Current-account surplus set to rise as export competitiveness improves.	Dec.	+ 7%	Sept.	0	8.50%	.3953	Interest rates ease in wake of lower German rates.	**Netherlands**
0	Trade surplus in 1981 was kr. 13.7 billion vs. kr. 5.7 billion in 1980.	Nov.	+12%	Aug.	+13%	9.00%	.1684	Monetary policy remains restrictive.	**Norway**
56	Crawling peg devaluation increased to 0.75% per month.	Sept.	+24%	June	+24%	18.00%	.0150	Monetary growth remains high.	**Portugal**
184	1981 current-account deficit was $5.3 billion; 1982 deficit forecast to decline.	Oct.	+14%	Sept.	+11%	8.00%	.0102	Funds still freely available; important rates firm.	**Spain**
0	Jan.-Nov. 1981 trade-deficit was kr. 1.3 billion, vs. kr. 11 billion year earlier.	Oct.	+10%	n. a.	—	11.00%	.1763	Monetary conditions eased no further.	**Sweden**
0	Strong exports and inventory cutback bolster trade balance significantly.	Dec.	+ 7%	Sept.	− 5%	6.00%	.5390	Central bank uneasy over strong Swiss Franc vs. DM.	**Switzerland**
0	Government repays U.S. $ debt to Canadian banks	Dec.	+12%	Sept.	− 1%	14.72%	.8357	Prime rate reduced to 16.5%.	**Canada**
0	Current account in 1981 was in large surplus.	Dec.	+ 9%	Dec.	+ 6%	12.00%	—	Interest rates jump as money accelerates.	**United States**

World Interest Rates

market rates of Jan. 27, 1982; bond yields as of Jan. 22, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	14.72	13.937 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.50	6.00	5.50
Day-to-Day Money	14.00 January 28	14.50	14.50	9.85	15.125	10.00	20.625	9.75	6.50	6.75
Treasury Bills 91-day, Middle Rates	12.77 discount basis	14.35	13.26	15.00	n. a.	n. a.	19.50 120-days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	13.00 finance paper discount basis	14.75 finance paper 15% tax w/h	12.90	13.90 Certified	15.25 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.40	14.75 15% tax w/h	13.812	13.90 Certified	not traded	9.90	23.40	no market	8.75	no market
Government Bonds Long-term, new and old issues, average yield	14.64	15.82	14.97	11.216 20% tax w/h	15.98	9.86	20.88	11.21	5.42	7.470
Industrial Bonds prime, long-term, new and old issues, average yield	15.80 Aa Industrials	17.00	16.19	17.583	17.28	9.95	20.36	12.50	6.325	7.18
Bank Short-Term Rate to Best Borrowers (prime rate)	15.75	16.50	15.50	18.00	16.85	14.00	22.50 ⅛ quar'ly fee on outstdng.	12.00	9.9375	6.00
Bank Time Deposits 3-month	13.875 Cert. of Dep.	14.50	14.562	15.10	15.25	10.20	10.75	10.50 large deposits	7.50 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	15.1875	no market	14.50	no market	15.875	10.3125	no market	10.375	9.00	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8357	1.8680	.0254	.1691	.4300	.000803	.3953	.5390	.004349
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.239 *D*	.959 *D*	4.483 *D*	1.174 *D*	4.527 *P*	7.426 *D*	4.86 *P*	6.042 *P*	8.303 *P*

Eurodollar Deposits

(London, interbank, bid)

January 28

7-day	14.00
1-month	14.50
3-month	14.0625
6-month	15.50

International Arbitrage

(3-month, hedged) **+** *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	+ .651
U.S.-Canada Treasury Bills	− .681
U.S.-Canada Finance Co. Paper	−1.308
Eurodollars-U.K. Local Auth. Deposits	n. a.

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.875
Over 7 yrs.	16.25
DM Bonds	
7 yrs. and under	10.50
Over 7 yrs.	10.00

Gold Price

London
afternoon fixing

381.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	8.9 (Dec.)	12.1 (Dec.)	12.0 (Dec.)	14.0 (Dec.)	6.3 (Dec.)	17.9 (Dec.)	6.6 (Dec.)	3.6 (Nov.)
Industrial production*	−4.7 (Dec.)	−2.9 (Nov.)	0.5 (Nov.)	−1.5 (Oct.)	0 (Nov.)	−0.3 (Nov.)	2.6 (March)	6.0 (Oct.)
Trade balance† *(billions of local currency units)*	−$4.41 (Nov.)	C$1.2 (Nov.)	£0.33 (Dec.)	−FF6.43 (Nov.)	DM3.95 (Nov.)	−Lit.1,150 (Nov.)	−SF0.24 (Dec.)	¥139 (Nov.)
Money supply (M1)*	6.3 (Dec.)	−3.7 (Nov.)	10.7 (Nov.)	15.8 (Sept.)	−2.2 (Nov.)	8.9 (August)	−7.5 (Oct.)	8.4 (Oct.)
Velocity of money (M1)*	12.7 (March)	6.7 (June)	10.2 (Dec. '80)	n. a.	1.3 (June)	4.5 (June)	n. a.	2.7 (June)
Reserves minus gold *($ million, change from previous month)*	750 (Nov.)	1,730 (Nov.)	438 (Nov.)	114 (Nov.)	336 (Nov.)	−232 (Nov.)	1.002 (Nov.)	481 (Nov.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Structural Imbalance Shackles Israeli Economy

The Israeli economy rebounded from its dismal 1980 performance early in 1981, then faltered later in the year. Rekindled inflation put a squeeze on personal incomes, export growth slumped with the worsening recessions in Europe and the United States, and unemployment reached its highest level in more than 10 years. To be sure, some revival of economic activity in the second half of 1982 now seems likely. But real growth for the year is expected to remain relatively weak by historical standards. And the dual threat of a reacceleration of inflation and a widening of the perennial deficit in the current account of the balance of payments overshadows the current economic outlook.

The scope of any measures the authorities might take to remedy these problems is limited by a basic structural imbalance in the economy that stems from a burgeoning public sector and continued heavy dependence on foreign trade. Furthermore, the precariousness of the political situation in the Middle East precludes any dramatic policy action in the near term to correct that imbalance.

The severity of Israel's economic problems has only become apparent in the last few years. Prior to the late 1970s, the nation enjoyed robust real growth, owing largely to the government's growth-oriented policies aimed at securing full employment for a rapidly expanding population. In the 1960s, the average annual growth in real GDP was more than 9%. Even with the severe world recession of 1973-75, real annual growth over the last decade averaged 6%.

Two developments forced the government to abandon its high growth strategies in the late 1970s: The inflation rate shot up into triple digits and the second oil-price shock—coupled with stepped-up defense imports—widened an already gaping current-account deficit. Restrictive measures implemented at the end of 1979, which slowed economic growth, helped to narrow in the current-account gap in 1980 and 1981. But the inflation rate has remained stubbornly above 100%.

In discussions of proposals for the state budget for fiscal year 1982-83, Finance Minister Yoram Aridor last week warned that without significant cutbacks in public expenditures, prices could again double in the coming year. The public sector in recent years has consumed an increasing portion of Israel's scarce resources—at the expense of an innovative private sector, still in its expansion stage. But with more than one-third of the budget committed to defense spending, and another third obligated to servicing the public debt, the government has little latitude for economizing. Thus, the burden of adjustment has been hoisted upon the private economy.

In recent years, adjustment has been postponed through running a current-account deficit. And there is a temptation to continue along this path as long as that deficit can be financed. Given Israel's politically strategic position, there is little doubt that financing aid—either in the form of grants or loans—will be forthcoming. Nevertheless, the large and growing foreign-debt burden (over $18 billion or some 90% of GDP at the end of 1981) places added pressure on policymakers to take some sort of corrective action.

Policy-induced fluctuations

Determining appropriate policy in such an environment is not an easy task. And the roller-coaster-like path of the Israeli economy over the past two years, largely, reflects developments in economic policy.

Following buoyant growth and rapidly escalating inflation in the late 1970s, the government implemented a number of restrictive monetary measures that threw the economy into decline through the first half of 1980. Private consumption for the year slumped 3.4% in real terms. And the volume of fixed investment plunged 9.4%. Exports, which rose some 6% in volume terms, offset partially the decline in domestic demand. And increased government spending—chiefly defense outlays associated with the military redeployment in the Negev desert—helped compensate for the slack in private activity. Overall, real GDP growth in 1980, despite some revival of activity in the latter part of the year, slowed to 1.8% from 4.2% in 1979.

The recovery that began in the second half of 1980 was given an added boost in the early part of 1981 from a number of policies instituted by the then-new Finance Minister Aridor. These included reductions in income taxes and purchase taxes on durable goods and an increase in government subsidies paid on a range of basic commodities. Over the first half of the year, these measures restrained monthly increases in the Consumer Price Index to under 5%. However, later in the year, when some of these policies were partially reversed, economic activity flattened out and the inflation rate again soared to over 10% in some months. Unemployment climbed to over 5% —its highest level in more than 10 years—adversely affecting expectations and prompting consumers to save more out of current incomes. Nevertheless, because of the strength of economic activity in the early part of the year, private expenditures increased some 7% over their depressed 1980 level. Export growth slowed somewhat to about 5%, as Europe's long-awaited recovery was postponed by a worsening recession in the United States. Overall GDP growth

Structural Imbalance Shackles Israeli Economy

(continued from page 7)

for 1981 as a whole is estimated to have been somewhat over 4% in real terms.

Economic growth in 1982 is expected to show a reverse pattern to that experienced in 1981. Sluggish activity is likely to continue through the first half of the year followed by some recovery in the second half, as a rebound of the U.S. and European economies revives demand for Israeli exports. A reasonably restrictive monetary stance, combined with any new efforts toward fiscal stringency, will not engender a revival in business confidence. Thus, investment activity is not likely to make a comeback before midyear. Even with some pick-up in consumer spending and stockbuilding later in the year, real GDP growth for 1982 is expected to be a modest 3.5%.

On the inflation front, preliminary government forecasts predict that prices will rise at an annual rate of 90% in 1982. This would be an improvement over the triple-digit figures of the past three years. However, the results of past government efforts to contain inflation have been mixed; thus, the danger of reacceleration must be taken into account in making projections of economic performance.

As for the current account of the balance of payments, there are also indications that the progress made in 1980 and 1981 may be reversed. Sluggish economic activity over that period, combined with a heavy drawdown of inventories, helped to reduce the current-account deficit below $1 billion. But with export growth expected to weaken in 1982 and imports likely to rise as companies begin rebuilding depleted stocks, the deficit may widen to $1.0-1.5 billion. The deterioration may not become evident, however, before the second half of the year.

Dual dilemma

The challenge to Israeli policymakers for the 1980s is to design and implement policies adequate to counter the twin threat of a re-escalation of inflation and a growing current-account deficit. This assignment is made all the more difficult given that these two problems are linked via a structural imbalance in the economy.

The seeds of the current inflation were sown in the shadow of the Yom Kippur war and the subsequent four-fold increase in oil prices during 1973-74. Cost increases were absorbed and passed on in an atmosphere of buoyant economic activity. Nominal aggregate demand, kept high by a growing budget deficit in the aftermath of the war, was supported by monetary expansion. Inflation accelerated sharply during 1978-79, before the first stage of the most recent round of oil price rises through 1980-81. The additional oil shock came on top of an economy that was already overheated with expectations geared to a further acceleration in prices. This, in turn, led to an explosion of wage increases above those guaranteed by Israel's indexation structure.

Policy measures undertaken in recent years by the Israeli authorities to counter the problem of inflation have taken two forms. First, to guard against the inefficiencies engendered by unanticipated inflation, the widespread system of indexation has been extended. Second, through 1979 and 1980, determined efforts were made—at great political cost—to reduce the growth of the government budget and curtail monetary growth. Ceilings were placed on the expansion of non-directed credit, and a 12% surcharge was imposed on foreign currency borrowing.

More recently, the officially declared approach to curbing inflation has been one of gradualism, emphasizing further efforts to trim the budget deficit. But Israel's continued strong defense needs and the high cost of servicing the national debt mean that cutbacks must be at the expense of social and industrial programs—a difficult political task.

Given this constraint, the burden of any deflationary adjustment policy is likely to continue to be borne by the private sector just as in 1979 and 1980. But at the same time, for strategic reasons, Israel must remain a high-employment, growth-oriented economy. This situation, added to the country's almost total dependence on foreign sources of energy, is likely to postpone any serious attempts to come to grips with the persistent balance-of-payments problems.

Policy prospects

The structure of the Israeli economy and the political constraints on policy do not provide a great deal of hope at this time for much of an improvement in the long-term economic situation. Economic growth in the 1980s is likely to be below the historical average. The current-account problem will persist, at least in the short-run, increasing Israel's need for overseas finance. Political and strategic considerations are likely to prevent serious financing difficulties, however.

Nothing short of a radical restructuring is required to alleviate Israel's inflation and balance-of-payments difficulties. But such a dramatic change does not appear to be close at hand. It had been hoped that the Camp David Peace Agreement would enable resources to be shifted away from defense, hence reducing the government's borrowing needs. However, the generally unsettled situation in the Middle East and the unresolved dispute over Palestinian autonomy continue to make such a development extremely unlikely. Thus, economic policy is expected to follow a "middle way," with a gradualist approach to the reduction of inflation encompassing mildly deflationary measures.

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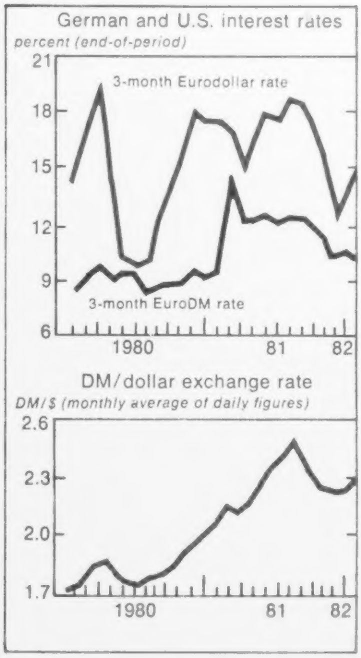
Why Did the Europeans Lower Interest Rates?

The recent small decline in European interest rates, led and coordinated by the German Bundesbank, was somewhat perplexing to the international financial community. It marks the first such reduction in two years to be undertaken in the face of rising U.S. interest rates and a consequent strengthening of the dollar on the foreign exchange markets. Previously, Europe's central banks chose to defend their exchange rates when faced with a strong dollar. They did this by maintaining or even raising interest rates, despite the sometimes considerable cost to their domestic economies in the form of falling capital investment and reduced economic activity. Such policy was predicated on the view that a rising dollar would boost domestic prices by increasing the local-currency cost of dollar-denominated imports—particularly oil—and thus threaten to set off a wage-price spiral. The costs of eventually arresting such a spiral, in terms of lost output, were seen to exceed the costs of stabilizing the exchange rate.

Interest-rate differentials and the value of the dollar


German and U.S. interest rates

DM/dollar exchange rate

At first sight, the recent move to lower rates would seem to indicate a marked policy shift. Closer examination, however, suggests that this view may well be overstated. For one thing, the European move was small: key interest rates were reduced by only one-half of a percentage point. In addition, policymakers believed that the exchange-rate cost of their interest-rate reduction would be low, based on such signs as the sharp turnaround in Germany's current-account balance and doubts about the durability of the recent rise in U.S. interest rates. Furthermore, the weakness of dollar-denominated commodity prices—including oil—means that a weakening of Europe's currencies against the dollar now carries a smaller inflationary impact than previously.

The European move can therefore be explained as much by a shift in the trade-off facing European policymakers as by a major shift in policy. That said, there is indeed some pressure for a change in policy emphasis stemming not only from the duration of the European recession and the resulting sharp rises in European unemployment rates, but also, from the lack of signals indicating an imminent domestically-led upturn.

The real test, however, would come if U.S. interest rates were to rise substantially later in the year. Europe would then be faced with an unpleasant choice: either accept a higher rate of imported inflation or risk aborting an incipient economic recovery by defending the exchange rate.

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Strong retrenchment inevitable for Ireland in light of continuing economic ills.

No matter what the outcome of this week's general election, Ireland faces bitter medicine in bringing its economy back to health. The severity of the country's economic problems is beyond dispute: Inflation is now running at an annual rate of 23% and shows few signs of abating; unemployment has reached 11% and is still rising; the deficit on the current account of the balance of payments in 1981 equaled an estimated 8% of total GNP and seems likely to deteriorate further; the country's foreign debt has risen to over 40% of GNP; and the government's huge deficit has expanded to nearly 17% of the national product. Although the Fine Gael government was unsuccessful last month in its attempt to introduce an exceptionally tough budget aimed at alleviating these ills, almost everyone—including the leader of the opposition party—recognizes that a policy of strong retrenchment is needed. Thus, the bulk of the proposed budget's restrictive measures are likely to be retained, irrespective of who wins the election.

Kronor devaluation prompts narrowing of Swedish trade deficit, but rekindles inflation.

The Swedish economy is still responding favorably to the effects of the 10% devaluation of the kronor in September 1981. Interest rates have fallen as the pressure on the exchange rate has diminished, and an encouraging export performance is helping to offset weak domestic demand. Preliminary figures indicate the trade deficit dropped to kr. 2 billion in 1981, substantially lower than 1980's kr. 10.9 billion gap. Growth is likely to pick up again in 1982 after last year's small GNP decline. But, despite the rise in imports that will undoubtedly follow the upturn in domestic activity, the current account of the balance of payments is not expected to deteriorate from the 1981 level. There is, however, also a dark side to the effects of this policy. The devaluation has worsened inflation, and in order to avoid a triggering of automatic indexation clauses the government was forced to reduce sales taxes. Indexation clauses for 1982 allow for wage increases if prices rise by more than 7% and it now looks certain that prices will in fact rise by much more. Thus, the country will continue to suffer from a wage-price spiral for some time to come.

Italian economy possibly past trough, but recovery will be slow.

Italy's volatile economy is sending out mixed signals. Provisional figures show that real GDP declined at a quarterly rate of 1.6% in the third quarter of 1981, following a 1.2% drop in the previous quarter. However, the third-quarter decline is attributable almost entirely to a seasonally adjusted 15% decline in industrial output in August which was then reversed in the following month. Moreover, the most recent figures, for November, show a sharp monthly rise. Survey data indicate a slight worsening in expected production, although exports appear to have performed strongly in the second half of 1981. All in all, it appears that the recession is now bottoming out but that the coming recovery will be sluggish. Monetary policy remains tight and high inflation continues to erode export competitiveness. For last year as a whole, real GDP is estimated to have declined by about 1%. And from the current perspective, a 1982 growth rate of about 1% appears likely.

Guatemala disrupted by political turbulence; outlook bleak.

Political turbulence has been the principal cause of the rapid deterioration of economic performance in Guatemala. Intense and growing political violence has not only shaken both local and foreign investor confidence leading to substantial capital flight, it has also hindered the ability to provide optimum care to crops and stifled trade flows and tourism. Compounding these internal problems have been high international interest rates and petroleum prices. At the same time, prices for major cash crops have been declining and no significant reversal is foreseen for the near future. Preliminary estimates indicate that real GDP growth slowed to 1.5% in 1981, down from 3.5% in 1980 and well below the 6% annual average growth for 1977-79. Guatemala's balance of payments, traditionally in good condition, deteriorated significantly in 1980-81; international reserves fell from $700 million at end-1979 to $190 million by November 1981. Until the political situation improves, prospects for stronger domestic and external performance are bleak.

Depressed commodity prices point to slower Thai growth, wider trade gap.

Thailand enjoyed robust real economic growth of 7.8% in 1981, up substantially from 1980's 5.8%. Agricultural production increased a record 5.3%, thanks to good weather. And industrial growth rose to 8.4% from 6.2% a year earlier, despite the world recession and its effects on exports. Consumer-price inflation decelerated to about 12.8% from 19.7% in 1980 as money growth slowed. Agricultural exports were up strongly in volume terms but much less in value because the prices for Thailand's major commodity exports declined sharply. As a result, the trade deficit increased to close to $3 billion from $2.8 billion in the previous year. In 1982, real growth is projected to slow to 6% as farm incomes decline and agricultural output responds to the depressed prices. Inflation is expected to moderate further to 10%. Despite increased use of domestic gas, the trade gap is expected to widen to perhaps $4 billion, as the prices of Thailand's major commodity exports remain low.

Indonesian officials hard pressed on policy owing to dismal export forecast.

A poor export outlook is forcing some tough policy decisions on the Indonesian government. Oil and gas revenues were essentially flat in 1981, and non-oil exports declined by 25% in nominal terms. Imports, on the other hand, continued to increase and the current account recorded its first deficit in several years—about $1 billion according to preliminary estimates. Continued weakness in the oil and commodity price outlook for 1982 suggests the current account will deteriorate further this year. With development expenditures on the rise, the government has been pressed to make some bold and politically surprising changes in fiscal and trade policies in order to offset the stagnating oil revenues. Despite large increases in domestic prices, authorities cut fuel and food subsidies by 39% in the fiscal 1982-83 budget. In addition, the government has initiated a series of export promotion measures, restricted imports of certain consumer products, and instituted a controversial "counter-purchase" scheme, whereby some of the foreign companies awarded government contracts are required to arrange for the export of Indonesian products equal to the value of materials and equipment brought into the country.

Increased foreign aid likely to relieve Ethiopian trade deficit.

Ethiopia, continues to suffer from severe foreign-exchange constraint owing largely to persistent price weakness of its major export commodity, coffee. According to preliminary reports, the fiscal 1980-81 trade deficit widened some 40% to $331 million, despite import restrictions. Technical assistance and other grants contained the current-account shortfall at $204 million, up from $126 million in the previous year. And a near-doubling of capital inflow held the overall balance-of-payments deficit to $59 million, which was financed by international reserve drawdown, IMF credit, and gold sales. Although both a modest improvement in export receipts—mostly the result of volume increases—and continued import restraint are expected in fiscal 1981-82, projections show only a marginal narrowing of the current-account deficit. On capital account, geo-political considerations and the country's reputation for prudent economic management are likely to produce increasing aid inflows from western nations, which could result in a somewhat lower deficit on the overall balance of payments.

Zambian economic upturn awaits copper-market turnaround.

Price weakness and reduced world demand for copper and cobalt led to an estimated 10% widening of Zambia's current-account deficit in 1981 to $555 million. Lower output of the minerals—which together account for about 95% of Zambia's export receipts—caused real GDP to contract by 1.8%. Moreover, mining company operation losses erased contributions to government revenue, giving rise to a budget deficit of $370 million. While no upturn is expected for cobalt this year, there is a chance that the copper market will strengthen toward year-end. The economy should also benefit from the impending merger of the two major state-controlled mining companies and their planned capacity expansion. Thus, while the balance of payments position remains grave over the near term and the government braces itself for a 56% higher budget deficit, there is cause for guarded optimism for the economy in 1983.

Economic Assumptions Critical to Budget Policy

The recent release of President Reagan's proposed budget for fiscal 1983 raises renewed questions concerning the effectiveness of his economic program. During the presidential campaign and throughout 1981, Reagan's advisers contended that tax reductions —chiefly reductions in personal income tax rates for individuals and accelerated depreciation for businesses —would spur economic growth sufficiently to move the budget toward balance. Cuts in non-defense spending would be large enough to accommodate sharply higher defense spending while still preserving the goal of a balanced budget in fiscal 1984. At the same time, the Federal Reserve was to steadily lower the rate of growth of the money supply so as to reduce inflation.

In the new budget proposal, however, the administration has calculated deficits for fiscal years 1982 and 1983 of $98.6 billion and $91.5 billion, respectively. Thus, market fears that large deficits would not soon disappear seem to be confirmed. Indeed, the administration acknowledges in the budget document the specter extremely large deficits can raise: "Due to the economic influences . . . and incomplete action on the administration's program last year, the budget deficit would soar into the triple digit range and remain there beyond 1987 without corrective action. Deficits of this magnitude would impose extreme pressures on financial markets, [and] undermine the outlook for continued monetary restraint, reduced inflation and economic growth. . . ."

The Reagan Administration's March 1981 budget proposal had estimated budget deficits of $41.7 billion in fiscal year 1982 and only $2.4 billion in fiscal 1983. This projection was based upon assumptions of economic growth of 5.2% and 4.9% in 1982 and 1983, respectively, along with 91-day Treasury bill rates of 8.9% and 7.8%, and increases in the GNP price deflator of 7.7% and 6.6%. The deficit numbers also assumed that Congress would pass the tax and spending reductions as proposed.

In explaining why the deficit projections are now so much larger, President Reagan blamed "recession, higher interest rates, declining inflation, and incomplete congressional action." The economic growth and interest-rate assumptions in the current budget plan are certainly much more pessimistic than those of last March: economic growth of 3.0% in 1982 and 5.2% in 1983, and interest rates to average 11.7% and 10.5%. (Inflation, however, is now expected to fall to 7.2% and 5.5%.) And Congress did fail to enact all the spending cuts Mr. Reagan had requested. Moreover, on its own initiative, Congress added many items to the tax bill—such as the "All-Savers" Certificate and the transfer of investment tax credits through leasing—that enlarged the Treasury's near-term revenue loss.

Asia and Oceania Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALAN			
			6 months ending	12-month change	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered
Asia	**Bangladesh**	Import restrictions depress industrial production; food crops hurt by drought and pests.	Aug.	− 4%	12.5*	$ 134	Dec.	138	− 54%	0.6
	Burma	Inflation close to zero in 1981, although price rise may be accelerating.	Oct.	+ 5%	5.6*	174	Dec.	212	− 19%	7.6
	China, People's Republic	Austerity budgets continue as recovery begins in heavy industry.	Sept.	+17%	242.2	246	Sept.	3,936	− 6%	2.2
	Hong Kong	Strong domestic demand supports real economy; government estimates 10% growth for 1981.	July	+23%	21.5	4,290	n. a.	—	—	—
	India	Economic program stresses liberalization of investment procedures, better public-sector performance.	June	− 2%	172.6*	257	Sept.	5,009	− 34%	4.0
	Indonesia	Government reduces oil and food subsidies to finance expanded development program.	Mar.	+ 9%	66.3	437	Dec.	5,014	− 7%	5.4
	Japan	Domestic demand remains in doldrums and exports are slowing.	Nov.	+13%	1,044.0	8,940	Dec.	28,208	+ 14%	2.5
	Korea	New cabinet announced measures designed to bolster business confidence.	Nov.	+21%	57.8	1,513	Dec.	2,679	− 8%	1.3
	Malaysia	Domestic activity continues to be dampened by poor export performance.	Aug.	−15%	22.8	1,697	Oct.	3,705	− 21%	3.9
	Pakistan	Unfavorable rains raise concern about wheat crop.	Sept.	+21%	27.8*	337	Dec.	721	+ 45%	1.6
	Philippines	Depressed condition likely to persist because of continued slow growth in industrial countries.	Aug.	0	35.1	726	Nov.	2,244	− 15%	3.1
	Singapore	Real growth for 1981 estimated at 9.7%, thanks to vigorous service industry.	Oct.	+ 5%	10.5	4,390	Sept.	6,828	+ 6%	3.0
	Sri Lanka	Capital expenditure to surge 40% in 1982 as work on Mahaweli Project accelerates.	Aug.	− 4%	4.1	277	Dec.	327	+ 33%	2.0
	Taiwan	New Four-Year Plan (1982-85) aims at 8% average growth.	July	+15%	40.2	2,278	Aug.	4,468	+161%	2.3
	Thailand	Lower export prices, particularly for rice, depress farm incomes.	Sept.	+21%	32.2	693	Dec.	1,732	+ 11%	2.1
Oceania	**Australia**	Government tightens foreign investment rules governing rural land, promotes auto competitiveness.	Dec.	− 5%	137.4	9,401	Dec.	1,671	− 1%	0.7
	Fiji	Development plan for 1981-85 aims at 4.7% average growth, emphasizing infrastructure development.	Sept.	+ 8%	1.0**	1,628	Dec.	135	− 19%	2.9
	New Zealand	Government pledges continuation of resource development strategy after narrow election win.	Oct.	+ 3%	21.2*	6,714	Dec.	666	+ 89%	0.7

*Fiscal year **1979

The new budget proposal attempts to address the problem of ever-increasing deficits through a variety of means. Further reductions in the volume of nondefense expenditures are planned; user fees for certain federal facilities would rise; management initiatives (better tax and debt collection, for example) would be undertaken; and tax "revisions" (read: increases) will be proposed. If all of the proposals requiring legislative action were passed, and if the economy were to perform as well as the Administration projects, the deficit in the so-called "out-years" (beyond 1983) would steadily decline to $53.2 billion in 1987.

But even this improving outlook for the deficit still depends crucially upon the economic assumptions. One percentage point lower economic growth increases the deficit by about $10 billion, while interest rates one percentage point higher add about $4 billion. Lower assumed inflation actually adds to the deficit because revenues would drop more than outlays: about $3 billion for each one percentage point.

Real economic growth prospects for the next two years do not seem as sanguine as the Administration's projections. Chase's own projections show considerably slower real growth in 1982 and 1983 than what the Administration is assuming, with the economy skirting another recession in 1983 as restrictive and, more importantly, uncertain money policy places limits on nominal growth. The inflation forecast very nearly matches the Administration's expectations—both are strongly based on the assumption that the Federal Reserve will maintain monetary growth within its 1982 target ranges, on average—while the interest rate forecasts are also quite similar.

The tax incentives to boost investment through increased saving will be unlikely to have a major impact as early as this year. With capacity utilization about 70%, there is little incentive for expansion plans. And with real costs of financing many percentage points above the rate of inflation, most firms may find it more profitable to restructure their balance sheets—by paying down debt or increasing liquid assets—with their increased cash flow from accelerated depreciation than even to modernize existing operations. So, the sector that is to be the engine of growth may be a little slow in leaving the station.

If this worse economic performance were to occur, the fiscal 1982 deficit could be about $15 billion higher, and the fiscal 1983 gap could grow by even more. Despite the prospect of continuing deficits exceeding $100 billion, however, the Reagan Administration could still be judged a success by its favorite yardstick—slowing the growth rate of federal expenditures sufficiently so as to reduce the share of GNP claimed by the government. Ultimately, it is the level of expenditures, not taxes, that is most important to the economy. Whether the government finances its expenditures currently by taxation, or shifts the liability into the future by borrowing, an equal amount of resources would be transferred. It is this task of reducing the resource transfer that the 1983 budget puts squarely into the hands of Congress.

Douglas L. Bendt

CE OF PAYMENTS		MONEY AND BANKING							
use of IMF credit, millions of dollars	current influences on payments	12-month changes				exchange rate in U.S. dollars	change from year earlier	current monetary conditions	COUNTRIES
		latest data	consumer prices	latest data	money supply(M1)	February 9, 1982			
32	Import restrictions start to slow import payments.	Sept.	+12%	Sept.	+20%	.0518	−20%	Credit conditions continue restrictive.	**Bangladesh**
5	Exports up 22% in first nine months of 1981.	Oct.	+ 4%	Apr.	+13%	.1348	− 6%	Pegging of kyat to SDR maintained.	**Burma**
531	Imports rising after demand restrictions last year.	Dec.	+ 8%	Sept.	+23%	.5590	−10%	Money supply stable or declining at end-1981.	**China, People's Republic**
—	Growth in both exports and imports slows.	July	+15%	July	+ 3%	.1709	−10%	Interest-rate ceilings on short-term deposits to be lifted.	**Hong Kong**
68	Cutback in IDA funds will force borrowing on less concessional terms.	Oct.	+13%	July	0	.1105	−10%	Credit continues restrictive under IMF program.	**India**
0	Foreign investors required to export Indonesian goods to get import licenses.	Oct.	+10%	Aug.	+27%	.0016	0	Rupiah weakens slightly, responding to payments deficit.	**Indonesia**
0	Government reduces non-tariff trade barriers in attempt to ease trade friction.	Dec.	+ 4%	Oct.	+ 8%	.00424	−14%	Ceilings on bank lending lifted for the first quarter.	**Japan**
1,24	Government marks down won, aiming to improve export competitiveness.	Nov.	+16%	Nov.	0	.0015	− 2%	Direct control on bank credit lifted.	**Korea**
22	Japanese-style trading company formed to help expand export markets.	Sept.	+11%	Sept.	+ 9%	.4425	− 1%	Loss of reserves moderating domestic money growth.	**Malaysia**
75	Rupee delinked from strong dollar in response to sluggish exports.	Oct.	+13%	Oct.	+ 9%	.1000	− 2%	Credit conditions continue restrictive under IMF guidance.	**Pakistan**
95	Oil imports could slow if large stocks are run down.	Oct.	+11%	Oct.	+10%	.1218	−10%	Easing of reserve requirements will boost liquidity.	**Philippines**
0	Government Investment Corporation plans to invest surplus funds abroad.	Sept.	+10%	Sept.	+ 7%	.4761	− 1%	Interest rates decline further.	**Singapore**
40	Current-account deficit was $430 million in 1981, vs. $660 million in 1980.	Oct.	+18%	Sept.	+16%	.0500	−12%	Last drawing made under IMF Extended Fund Facility.	**Sri Lanka**
0	Trade surplus estimated at $1.4 billion for 1981.	Aug.	+17%	Aug.	+ 8%	.0286	− 1%	Interest rates lowered further.	**Taiwan**
73	Continuation of commodity-price recession widens trade gap.	Oct.	+12%	June	+ 8%	.0455	−10%	Foreign-loan tax holiday renewed.	**Thailand**
0	A$ allowed to slip against currency basket owing to overall payments deficit.	June	+ 9%	Oct.	+ 7%	1.1000	− 6%	Money supply growth on government target path.	**Australia**
0	Weak commodity prices cause widening current-account deficit.	Dec.	+10%	Nov.	+ 9%	1.1160	−11%	IMF grants $15 million to compensate for export shortfall.	**Fiji**
3	Meat exports at record level in 1981.	June	+15%	Oct.	+ 3%	.7940	−16%	Money supply and credit growth continue high.	**New Zealand**

World Interest Rates

market rates of Feb. 9, 1982; bond yields as of Feb. 5, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	14.74	13.791 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.50	6.00	5.50
Day-to-Day Money	15.24 February 10	15.00	14.375	12.25	14.75	10.00	20.375	10.25	2.75	6.75
Treasury Bills 91-day, Middle Rates	14.14 discount basis	14.70	13.50	15.15	n. a.	n. a.	18.899 90-days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	14.75 finance paper discount basis	15.45 finance paper 15% tax w/h	12.95	13.90 Certified	15.00 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.90	15.40 15% tax w/h	13.812	13.90 Certified	not traded	9.90	23.20	no market	8.3125	no market
Government Bonds Long-term, new and old issues, average yield	14.74	16.125	14.48	11.065 20% tax w/h	15.91	9.79	20.85	11.10	5.48	7.671
Industrial Bonds prime, long-term, new and old issues, average yield	15.70 Aa Industrials	17.00	15.94	15.808	17.12	9.85	20.41	12.13	6.40	7.15
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	16.50	15.00	18.00	16.85	14.00	22.50 ⅛ quar'ly fee on outstdng.	12.00	9.50	6.00
Bank Time Deposits 3-month	15.125 Cert. of Dep.	15.50	14.562	15.00	15.00	10.00	10.75	10.25 large deposits	8.00 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	16.1875	no market	14.75	no market	15.75	10.25	no market	10.1875	8.3125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8227	1.8490	.0248	.1662	.4223	.000789	.3841	.5241	.00424
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.5265 *P*	1.622 *P*	2.479 *D*	.4987 *P*	5.065 *P*	6.319 *D*	5.532 *P*	7.547 *P*	9.497 *P*

Eurodollar Deposits

(London, interbank, bid)
February 10

7-day	15.50
1-month	15.9375
3-month	16.1875
6-month	16.1875

International Arbitrage

(3-month, hedged) ✦ in favor of U.S. dollars

U.S.-U.K. Treasury Bills	— .796
U.S.-Canada Treasury Bills	— .386
U.S.-Canada Finance Co. Paper	—1.015
Eurodollars-U.K. Local Auth. Deposits	— .1845

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.875
Over 7 yrs.	16.125
DM Bonds	
7 yrs. and under	9.81
Over 7 yrs.	9.75

Gold Price

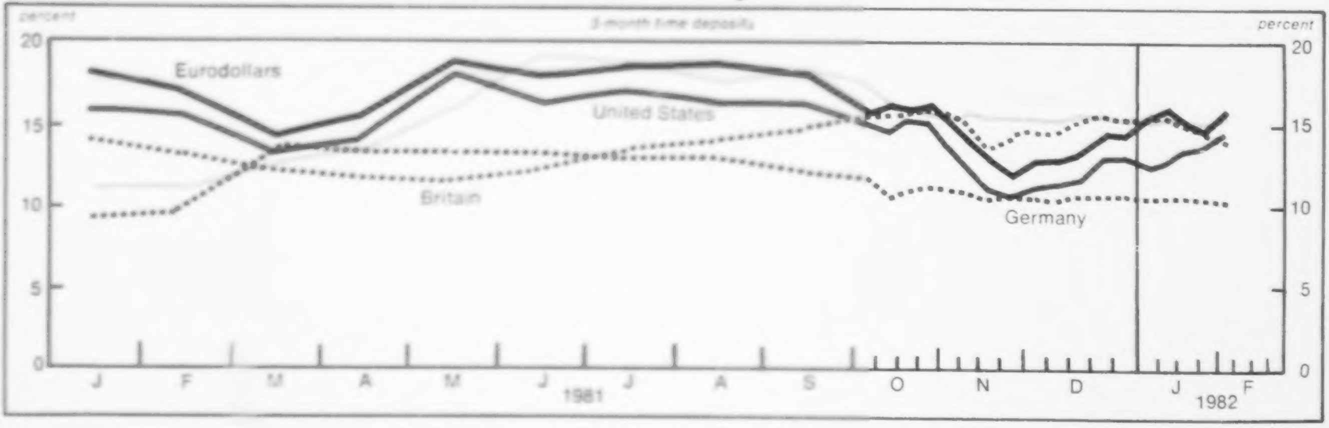
London afternoon fixing

378.50

(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Interest rate movements in major industrial countries



Spain: Slow Progress on the Road to Recovery

Spain's protracted economic slump may at last have bottomed out. Unexpected strength in exports and tourism has generated cautious optimism that a modest recovery may have begun in the second half of 1981. At this point, however, the turnaround is tenuous, at best. There is much about the Spanish economy that remains troublesome: Weak domestic demand persists despite prospects of another expansionary government budget; unemployment has continued its relentless upward climb and is projected to worsen throughout this year and into 1983; and private domestic investment remains depressed in the face of sluggish demand and political uncertainty. There are subtle signs that Spain has made progress in the slow process of structural adjustment, which over the longer term will help to correct these problems and bring the economy back to health. But with the external sector left as the principal source of economic salvation in the short run, the scope for a strong and early revival is limited.

In its post-Franco era, Spain has had to grapple not only with two oil price hikes, but also with the gradual opening up and liberalization of the economy during a period of political transition. The result has been a fundamental change in economic performance. Since 1975, economic growth has fallen below the OECD average. Unemployment has soared as companies once protected under the isolationist policies of the old regime have been forced to shed surplus labor in order to remain competitive. A broad-based rise in almost all forms of public expenditures has pushed the government budget from surplus into a large and growing deficit. But despite burgeoning public consumption, overall domestic demand has recently weakened. Rising unemployment has curtailed private spending, while at the same time, political uncertainty and a squeeze on profits have inhibited private investment—except for a few large projects by multinational corporations. The balance of payments began to worsen in mid 1979, following a rise in the price of oil and the institution of government policies designed to stimulate imports. The external sector then became a net contractive force in 1980 when exports were adversely affected by exchange-rate movements.

In essence, the Spanish economic experience in 1981 was a continuation of the same dismal trends. Economic growth languished at less than 1% in real terms, as the number of unemployed Spaniards rose to 1.74 million, or 14% of the labor force, in spite of the government's increased deficit spending. Government officials made little attempt to contain the deficit. A strong peseta early in the year aggravated exports and tourism, resulting in a current-account deficit estimated at $5.5 billion, up from $4.6 billion in 1980.

A few positive signals however, could also be deciphered from last year's gloom. Although weak, the economy did manage to sustain positive growth despite a severe drought that cut Spain's agricultural harvest by some 6%. This was an achievement matched by few OECD nations. Real wages actually began to fall in the face of the high and rising unemployment. And with private credit demands weak, the Bank of Spain was able to maintain monetary policy tightly enough to achieve a marginal improvement in the rate of inflation: down to 14.4% in 1981 from 15.6% in 1980 and 15.7% in 1979. In addition, perceptible progress was made in addressing some of the structural problems of the economy. After lengthy delays, consumer energy prices were raised substantially and implementation of National Energy Plan investments was begun. Furthermore, additional steps were taken in the liberalization of both the financial system and the labor markets. These signs bode well for Spain's eventual return to a healthier economy over the long run, even if they have only marginal significance for the immediate outlook.

Near-term prospects

The capacity for a robust recovery in 1982 is severely limited. Although the Spanish government has forecast real growth of 3%, private forecasters are not nearly so optimistic. Domestic activity is far from buoyant despite yet another expansionary budget. There is little to bolster consumer demand, as unemployment is expected to continue rising throughout the year before stabilizing sometime in 1983, and real wages are anticipated to decline further. Similarly, private investment demand will probably remain depressed in the face of inadequate orders, high interest rates, and political uncertainty.

The external sector is the most likely source of recovery, and even here prospects are not especially good. Europe, Spain's major export market, is moving out of recession only very slowly. And demand for big-ticket Spanish exports, such as motor cars, is anticipated to be especially weak during 1982. In addition, Spanish exporters have been experiencing declining competitiveness over the last year as the peseta has remained generally in line with European currencies while Spanish costs have risen more rapidly. Nevertheless, the export rally in the latter part of last year augurs well for Spanish exports. And with import demand weak, the external sector is expected to be a net contributor to economic growth in 1982. Overall, real GDP growth is projected to be a modest 1.5%—somewhat stronger than last year. However, the effects of last year's drought could exert some residual drag on the economy.

Spain: Slow Progress on the Road to Recovery *(continued from page 7)*

With so fragile a recovery in process, Spain's ever expanding fiscal deficit is generating increasing concern. According to the official 1982 budget plan, the deficit will rise to pta. 700 billion from a budgeted pta. 400 billion in 1981. However, in view of the government's past record for overshooting its projections (the *actual* 1981 deficit was an estimated pta. 700 billion, 4% of GDP), the actual deficit will almost certainly reach pta. 1 trillion or 5% of GDP. Compared with other countries, Spain's deficit absorbs a relatively small portion of its national product. Furthermore, most of the fears about the deficit have centered more on its growth than on its level. For 1982, however, there is some concern that because the huge fiscal gap will largely be financed domestically, there could be some crowding out of private sector investment expenditures. Given expectations of what the Bank of Spain's stance on monetary policy is likely to be, funding the large deficit will add to other pressures on interest rates.

On the positive side, the forecast points to a small improvement in Spain's balance of payments in 1982—the first since 1978—although an overvalued peseta could be a detrimental force. The current-account deficit is projected to decline to $4.5 billion, with much of the improvement coming from services receipts, particularly tourism. The 1982 World Cup Soccer Tournament will be played throughout Spain this summer and should attract large numbers of tourists from Europe and South America.

Another positive development in 1982 is likely to be some additional easing of inflationary pressures. It is anticipated that the Bank of Spain will continue its gradual reduction of monetary growth. This action will be aided from the cost side by further moderation in real wages and by softening world oil prices. The average annual rate of consumer price inflation is expected to drop to 13.5% as a result, although food prices will come under some pressure because of the drought.

Unresolved issues

Despite advances in the structural transformation of the Spanish economy, the road to revival is still likely to be slow and full of potential pitfalls. The country's dearth of domestic energy resources, for example, leaves the economy still susceptible to sudden rises in the price of imported oil.

In addition, in spite of the many new and highly efficient investments made in a relatively liberalized economic environment, the country remains saddled with an old, inefficient industrial base. And with Spain's persistently depressed investment performance, this will continue to be a drag on the economy. Gross fixed capital formation is one of the lowest in the OECD. Moreover, a significant proportion of the new investments are not in direct capacity generating projects.

The implications of Spanish entry into the European Economic Community (EEC) are of great importance to the economy. It is now certain that the original deadline of a 1983 entry is not feasible as, because of internal disagreements in the EEC, negotiations have yet to begin. The long-term reality of this move for Spain will be whether the benefits of expanded export markets will exceed the cost of losing domestic markets to EEC imports. The current level of inefficiency in Spain's domestic industries offers the opportunity for substantial import penetration by EEC producers. Spain's hope is that negotiations with the EEC will result in a period of transition long enough to correct some of these inefficiencies. On balance, membership in the EEC is expected to be beneficial to the Spanish economy, although the initial years could be difficult.

Unemployment has become the most politically important economic issue in Spain—and one that is not likely to be resolved soon. The underlying cause has been a necessary shedding of excess labor by industries previously over-manned because of restrictive labor legislation. Many companies are still carrying surplus labor that will need to be released. Thus, unemployment is not expected to peak until sometime in 1983, when the number of jobless may rise as high as 2 million. As a result, socio-political pressures could result in further expansionary fiscal and monetary policies, which would aggravate inflation and probably worsen Spain's balance-of-payments position.

Despite all of Spain's problems and vulnerabilities, there is some room for optimism in the outlook beyond 1982. Productivity growth has been high in recent years, averaging 4.3% over 1975-80—a level only slightly lower than that for Japan. And a number of new investments in Spanish industry have shown themselves to be highly competitive in international markets. Although Spain's short-term prospects are only modest, there is now some evidence that the country has begun to adjust to changing economic conditions.

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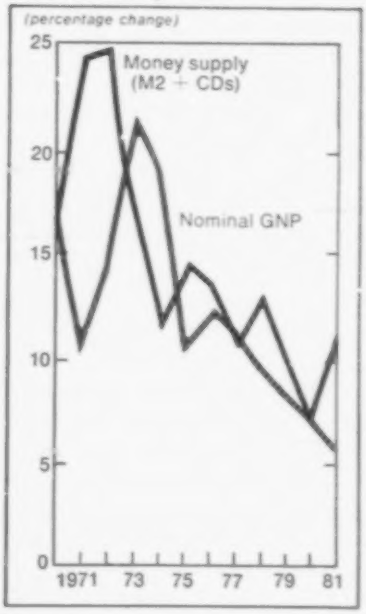
Japanese Monetary Policy Suggests Weak Yen

Recent and targeted money growth in Japan has cast some doubt on the validity of the current consensus forecast for 1982—especially regarding the outlook for the yen. According to private forecasters, the Japanese economy is likely to record real growth of 3%-4% this year, about the same as the estimated 3.2% growth of 1981. In addition, consumer-price inflation is expected to moderate to 3%-4% from 4.9%, the current account surplus is projected to widen sharply to perhaps $15 billion from the $4.7 billion surplus of 1981, and the yen is expected to appreciate to below 200 yen per dollar by yearend. These projections seem less plausible, however, when juxtaposed with the current stance on monetary policy.

In an attempt to spur domestic demand, the Japanese monetary authorities have pursued a relatively expansionary monetary policy since early 1981. As a result, M2 (currency and demand and time deposits) plus certificates of deposit (CDs) grew at an 11% rate between yearend 1980 and yearend 1981. Furthermore, the monetary authorities have continued this expansionary monetary policy, announcing a target growth rate for M2 plus CDs of 11% (at an annual rate) for the first quarter of 1982. This money growth, however, is considerably in excess of the recent and forecast growth in nominal GNP of 6%-7%. Any excess supply of money that results will require an equilibrating adjustment that has several important implications for the performance of the economy, and for the yen in particular.

Japan's monetary and economic growth



With the liberalization of the Japanese capital markets in December 1980, the excess supply of money arising last year was manifested in low real interest rates relative to those in the United States and then dissipated primarily through an outflow of capital. As a result, the yen was relatively weak, averaging 220 yen per dollar in 1981, and the deficit on capital account soared to $7.3 billion from only $1.6 billion in 1980. Over 1982, if the relatively expansionary monetary stance is maintained, the capital account may continue to be the primary outlet for an excess supply of yen.

Another possibility—but one that currently seems less certain—is that a disequilibrium in the Japanese money market could be alleviated partially through increased purchases of domestic or foreign goods and services. This would raise either real output or domestic prices and would result in a smaller-than-expected current-account surplus. In any event, an excess supply of money in the Japanese economy seems likely to lead to a weaker yen in 1982 than is now being predicted by most private forecasters.

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Upcoming British budget unlikely to contain expansionary measures.

In spite of Britain's 12.3% unemployment rate and another 2% decline in real GDP in 1981, the Thatcher government shows no signs of softening its stance on economic policy. Consequently, the new budget, due to be announced next week, is likely to contain little that might give a fiscal boost to the economy, other than perhaps an indexing of the tax system to take account of recent inflation—still stubbornly at 12%. As a result, the economy is likely to stay close to the trough of its recession and GDP will grow by somewhat less than 1% in 1982. The budget and the resultant course of the economy should attract renewed interest in sterling, however, as the inflation rate is likely to begin to come down over the year and the balance of payments is expected to remain in substantial surplus.

Recession poses dilemma for monetary policy in Switzerland.

Economic activity in Switzerland has been contracting since mid-1981. Retail sales volume has been running some 1%-2% below last year's level, industrial production has been flat, and labor market indicators have also confirmed the overall picture of economic weakness. The Federal Commission, in line with most private forecasters, now expects real GDP to decline by some 1.5% in 1982, following growth of 1% last year. This poses a policy dilemma for the Swiss National Bank (SNB). Domestic labor costs are rising sharply and despite strong opposition, the SNB would like to retain its current tight monetary policy to prevent a further step-up in inflation. Certainly the SNB will wish to avoid any further appreciation of the Swiss franc in terms of the German mark, since this would seriously impair export competitiveness. Thus, Swiss policy initiatives are likely to mirror developments in Germany. If U.S. interest rates turn down shortly, this would weaken the dollar and prompt some easing in German monetary policy. Swiss interest rates could then fall rapidly, as the SNB is prepared to accept franc weakness in terms of the mark.

Declining oil output likely to mean lower tax revenues for Norway.

Norway's output of oil and gas fell in 1981 to 48.8 million tons from 49.5 million in 1981, marking the first decline since the country began production. The current glut on the world's oil market has prompted huge downward revisions in the government's oil-price and production forecasts and a scaling back of anticipated tax receipts. Tax-revenue projections for 1982-85 have been reduced by more than 40%—down to kr. 100 billion from kr. 170 billion originally forecast. This suggests that the ruling conservative party may have difficulty in making the generous tax cuts promised during its election campaign. Moreover, another wage-price spiral is threatening to emerge. Prices have jumped 3% with the lifting of the price freeze imposed last August, bringing the year-on-year inflation rate back up to 12%. Nevertheless, the Norwegian outlook still looks favorable. Even if oil prices do fall still further, Norway's enormous oil stocks will continue to ensure the country substantial income and one of the highest standards of living in the world.

Uruguay's economy subdued, but strides made in moderating inflation.

Following two years of strong growth, the Uruguayan economy moved into a slowdown phase in 1981. Preliminary estimates indicate real GDP grew only 1% last year, after robust growth of 8.5% and 4.7% in 1979 and 1980, respectively. Large currency devaluations and recession in neighboring Argentina have contributed to the sluggishness, as have soft prices and depressed markets for Uruguay's beef and wool exports and complaints by exporter groups that the Uruguayan peso is overvalued. In real terms, the agriculture, cattle, construction and commerce sectors declined last year and manufacturing grew by only 1%. On the bright side, however, the Uruguayan authorities have had notable success in reducing the rate of consumer price increases from 43% at end-1980 to 29% at end-1981 by following the policy of devaluing the currency below the inflation rate. The government is hoping to eventually bring domestic inflation down to international levels but plans to ease the exchange-rate policy a little by allowing a slight monthly increase in July and August of this year. This may help exports somewhat but the overall rate of economic activity is likely to remain subdued.

Argentine authorities adopt tough stance to bring down inflation.

The Argentine government is pursuing a difficult stabilization program designed to reduce strong inflation expectations in the economy. Despite an already weak economy—real GDP fell 6% in 1981—policymakers have adopted a bold plan to hold constant the public-sector wage bill through the first quarter of 1982. Since wages account for more than half of government spending, the intention is to bring down the public deficit and the consequent need for central bank financing. The hope is that this will lead to slower growth of the money supply and thus a lower rate of inflation. Corrective increases in public service charges boosted the inflation rate up to an annual rate of 146.8% in January, but this jump had been anticipated by the authorities. By curbing public spending, the government believes the rate of inflation will gradually decline in subsequent months and finish below 100% by the end of 1982.

Depressed commodity prices leave Malaysia with gaping current-account deficit.

Like most commodity-dependent Asian economies, the performance of the Malaysian economy in 1981 was strongly influenced by the recession in the industrialized countries and the resultant steep decline in commodity prices. Real growth is estimated to have slowed to 6%-7% from 8% in 1980, despite efforts to support domestic activity through government spending. At the same time, inflation rose to near 10% from 7.8% the previous year. The trade account, which was in surplus by $2.3 billion in 1980, is likely to have turned into deficit as the prices for Malaysia's main commodity exports plunged. As a result, the current-account deficit is estimated to have widened to about $2.6 billion from $471 million in 1980. This year, ambitious government spending is expected to maintain real growth in the 6%-7% range. Inflation, however, is likely to remain around 10%. And with little recovery in commodity prices expected before the end of 1982, the current-account deficit could easily mount to well over $3 billion as the trade and service accounts continue to deteriorate.

Inflation-fighting tack slows Taiwanese economic growth.

Government efforts to stabilize prices set off a major growth slowdown in Taiwan in 1981. Although the real growth of 5.5% estimated for the year is quite respectable by international standards, it is a far cry from the 10.4% average of the previous five years. The government's tight money and credit policies did cut consumer price inflation in half to about 9.5% in 1981 from 19% the year before. But industrial production suffered as a result. Especially troublesome was low private investment, particularly in new projects. Earnings also declined drastically in some capital-intensive industries, such as petrochemicals, which faced slack world demand as well as high materials costs. Trade, however, was good and the trade balance moved into surplus by $1.4 billion in 1981, according to preliminary estimates. The outlook for Taiwan suggests stronger growth in 1982. Already the new cabinet formed in December has adopted a number of investment-boosting measures, indicating a shift back to a high-growth strategy in contrast to the previous team's emphasis on price stability.

Capital spending giving boost to Bahrain's economy.

Despite declining oil production, the Bahraini economy is continuing its recovery from the slowdown of 1979. Official statements have intimated renewed growth averaging about 5% in 1980 and 1981, with the major impetus stemming from an increase in government capital spending. The minister of finance recently outlined a $7 billion program for 1982-85 which strongly emphasizes infrastructure, especially power generation and water desalination. Meanwhile, good progress is being made on a number of heavy industrial projects involving inter-Arab cooperation and use of local gas resources. In addition, the long-planned Bahrain-Saudi Arabia Causeway is finally about to become a reality. The construction contract has been awarded to a Saudi-Dutch consortium and initial dredging has begun even though the project could take five years to complete. Although the long run impact of the causeway is a matter for debate, over the shorter run, the construction activity should provide positive support to the Bahraini economy.

Investment Unlikely to Boost Economy

If there was a silver lining at all in the revision of the fourth quarter GNP statistics, it was the better-than-expected performance of real business investment. Preliminary data had shown an 11% decline; however, this figure was revised, indicating only a 5.3% decrease—just slightly greater than the revised 4.7% decline in overall GNP. In contrast, during the second quarter of 1980, real GNP dropped 9.9% while fixed investment plunged 19.9%. But before too much optimism emerges about investment propping up the economy or leading a sustainable recovery, some words of caution are in order.

Real business-fixed-investment in both 1980 and 1981 was below its 1979 level. The usual excuse given for this weak performance is the persistently high levels of interest rates. Some analysts have likened the currently high rates to a hurdle that must be overcome before investment will proceed. Along this line of thinking, it has been argued that the business tax cuts via accelerated depreciation more than offset this hurdle, therefore, more investment should take place.

This argument, however, has two basic shortcomings. One deals with interest rates, the other with the firm's cash flow. High interest rates by themselves are not necessarily a barrier to investment. If demand conditions are such that a firm's expected rate of return exceeds the interest rate, then the investment will still take place.

As it turns out, interest rates *have* risen in the last two years. In fact, the rise has been large enough that interest rates now substantially exceed the rates of return on investment that can now be earned in many industries. To correct this imbalance, either investment must fall—that is, there must be a reduction in the capital stock by writing off obsolete and inefficient plant and equipment—or investment possibilities must be improved through technological innovation.

On the other hand, the increase in cash flow that the corporate sector will receive from the accelerated depreciation legislated last year will not completely offset the impact of higher interest rates. Firms have at least three uses for cash flow: dividends, fixed investment, and other investments (inventories, liquid assets, buying back debt or equity). It seems unlikely that an increase in cash flow would go entirely into any one category on an economy-wide basis. However, an individual firm might well decide to forego fixed investment entirely if none of its physical investment opportunities have a sufficiently high rate of return. Investment in Treasury bills, or the repurchase of outstanding debt—both with an assured profitable return—or an increase in the firm's dividend payout might well be more attractive alternatives.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF				
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use o credit lions of
Argentina	Economy is in a recession with strong inflationary pressures and high unemployment.	Mar.	− 8%	117.0	$4,333	Oct.	3,473	−55%	4.8	0
Bolivia	New law passed to guarantee company operations and promote foreign investment.	Sept.	− 6%	6.1	1,090	Dec.	100	− 6%	1.3	71
Brazil	Some recuperation of business activity in January, especially in consumer goods purchases.	Nov.	+ 6%	233.2	1,896	Dec.	6,602	+14%	3.4	0
Chile	Government able to grant open-ended mining concessions to private investors under new law.	Oct.	−20%	22.8	2,060	Dec.	3,214	+ 3%	5.3	4
Colombia	Economic growth slowed to 3.2% in 1981 from 4% in previous year.	Sept.	−33%	36.8	1,360	Dec.	4,731	− 2%	11.3	0
Costa Rica	Central government budget deficit lowered to 5.6% of GDP in 1981 from 7.9% in 1980.	Aug.	+14%	4.6	2,063	Dec.	131	−10%	1.2	10
Ecuador	Economy slowing in response to fiscal and monetary restraints.	May	− 9%	11.0	1,321	Dec.	752	−26%	4.0	0
El Salvador	Government's 1982 budget at $844 million is only 6% higher than 1981—smallest rise in 10 years.	Aug.	−39%	3.3	690	Dec.	72	− 7%	0.8	44
Guatemala	Recent increases rescinded for internal prices of sugar cane and refined products.	Dec. '80	+ 1%	7.8	1,073	Dec.	150	−66%	1.0	11
Guyana	Sugar production being affected by shortage of harvesting machines.	June	+11%	0.6	635	Dec.	7	−46%	0.2	8
Honduras	One-third of $125 million in foreign loans in 1981 went toward housing.	Aug.	− 3%	2.4	651	June	112	−48%	1.4	3
Jamaica	Government reviewing investment proposals with potential value in excess of $1 billion.	Nov.	− 1%	2.4	1,096	Nov.	154	+57%	1.3	470
Mexico	Peso devaluation accompanied by 3% public budget cut, but wage demands could rise.	June	+40%	186.3	2,591	May	3.321	+38%	1.6	0
Nicaragua	State petroleum company established to distribute and sell products, explore new deposits.	Dec.	+28%	2.1	780	Dec. '80	70	−53%	1.1	2
Paraguay	Increased taxation effort is underway to reduce public sector budget deficits.	Oct.	− 4%	4.4	1,429	Dec.	806	+ 6%	18.1	0
Peru	Newly discovered deposits boost proven oil reserves to 900 million barrels; exploration intensifies.	Sept.	−17%	17.0	955	Nov.	1,028	−47%	2.3	38
Uruguay	Inflation rate decelerated in December but economy is also slowing.	Aug.	+32%	9.8	3,379	July	403	− 5%	2.9	0
Venezuela	New law requires public sector to purchase locally produced goods and services when available.	Oct.	+ 9%	60.4	4,345	Dec.	8,164	+24%	8.9	0

Reevaluating the M1 Upsurge

Recent economic data confirm the widespread view that the last three months' surge in money growth was not indicative of a rebound in total spending. Rather, the economy continued to weaken considerably through January. Such behavior is in marked contrast to previous periods of rapid money growth, during which total spending generally picked up along with the acceleration in money growth.

In November, December, and January, M1 grew at seasonally adjusted annual rates of 10%, 13%, and 23%, respectively. Such growth is similar in magnitude to that during the summer of 1980, when M1 grew at annual rates of 11½%, 14%, and 25% in June, July, and August, respectively. At the time it was widely believed that the economy would continue to be weak, and that the surge in money growth was some temporary aberration. As the economic data for this period became available, however, it turned out that total spending had already rebounded from that spring's very weak level. Over the summer, both retail sales and total business sales grew at annual rates of about 22%, and personal income rose by 13%.

The experience of 1980 led some forecasters to believe that the jump in money growth which began last November was an indication that total spending was rebounding much more sharply than had been anticipated. It is now apparent, however, that no such rebound occurred. In the November 1981-January 1982 period, personal income rose at an annual rate of only 3%, and both retail and total business sales fell.

It appears, then, that the indicator value of M1, while perhaps good in 1980, has been deficient of late. And yet the effect of money growth on interest rates in the two periods was the same: rates moved up significantly in response to rapid money growth. Indeed, in the recent period rates moved up more rapidly in response to the money bulge than they did in 1980—in part because of the memory of the 1980 experience. And it has only been very recently that rates have moved down somewhat—in part because the economy continued to weaken significantly despite the surge in money growth.

Unfortunately, none of this explains *why* money grew so rapidly in the first place. One hypothesis is that the severely weakened economy has caused the demand for "precautionary" money balances, or "liquidity," to rise dramatically. While this explanation certainly cannot explain all of the money bulge, it may have some validity. Indeed, the fact that 60% of the rise in M1 since last October was in the "other checkable deposits" category—which is composed of consumer transactions deposits similar to savings accounts—suggests that some consumer liquidity-building may have occurred. If this is the case, the recent monetary experience may be laying the groundwork for stronger consumer spending in coming months.

PAYMENTS		MONEY AND BANKING							COUNTRIES
IMF , mil- dollars	current influences on payments	12-month changes				exchange rate in U.S. dollars	change from year earlier	current monetary conditions	
		latest data	consumer prices	latest data	money supply(M1)	February 24, 1982			
	Peso exchange rate holding steady.	Jan.	+147%	Oct.	+127%	.0001	−81%	Some decline in interest rates expected.	**Argentina**
	Currency devalued in effort to improve external accounts.	Sept.	+ 33%	Oct.	+ 20%	.0227	−47%	Monetary policy is restrictive.	**Bolivia**
	Devaluation rate in line with inflation.	Jan.	+ 95%	Nov.	+ 66%	.0073	−51%	Money supply accelerated in January.	**Brazil**
	Domestic recession likely to hold current-account deficit near 1981 level.	Dec.	+ 10%	Sept.	+ 17%	.0263	− 3%	Liquidity is at low level.	**Chile**
	Government plans to control non-essential imports.	Nov.	+ 26%	Apr.	+ 35%	.0195	−13%	Monetary policy is restrictive.	**Colombia**
	Current-account deficit was $390 million in 1981, vs. $660 million in 1980.	Sept.	+ 41%	Apr.	+ 37%	.0589	n. a.	Tight credit policy continues.	**Costa Rica**
	Brazil becomes largest buyer of Ecuadorean oil.	Oct.	+ 16%	July	+ 21%	.0295	−19%	Monetary Board raises interest-rate ceilings.	**Ecuador**
	Coffee crop in 1981-82 down 22% from year ago.	Sept.	+ 13%	Oct.	0	.4045	n. a.	Net international reserves continue to decline.	**El Salvador**
	International reserves continue to decline.	Aug.	+ 12%	Sept.	+ 4%	par	0	Net foreign assets on the decline.	**Guatemala**
	Net international reserves are negative.	July	+ 20%	June	+ 9%	.4000	+ 2%	Net foreign assets shrinking.	**Guyana**
	External prospects negatively affected by low commodity prices.	Oct.	+ 10%	Sept.	+ 1%	.50018	0	Net foreign assets declining.	**Honduras**
	IMF stand-by targets being met.	Nov.	+ 5%	Sept.	− 22%	.5700	+ 1%	Monetary policy continues restrictive.	**Jamaica**
	Central bank no longer supporting currency.	Jan.	+ 31%	Aug.	+ 54%	.0275	−36%	Domestic interest rates being kept at high levels.	**Mexico**
	Major sugar plantation and refinery project in works to bolster export capacity.	July	+ 28%	Dec.	+106%	n. a.	—	Foreign assets position worsening.	**Nicaragua**
	Timber exports off sharply.	Sept.	+ 10%	Sept.	+ 3%	.0082	+ 2%	Bank liquidity is at low level.	**Paraguay**
	International payments prospects worrisome in face of large fiscal deficit.	Nov.	+ 72%	Oct.	+ 48%	.00205	−29%	Domestic credit expanding rapidly.	**Peru**
	Faster devaluation scheduled for July-August.	Dec.	+ 29%	Aug.	+ 33%	.0875	−13%	Central bank trying to reduce interest rates.	**Uruguay**
	Government attempting to diversify sources of external finance.	Dec.	+ 11%	Aug.	+ 7%	.2334	0	Interest rates adjusting to liberalized environment.	**Venezuela**

World Interest Rates

market rates of Feb. 24, 1982; bond yields as of Feb. 19, 1982

in percent per annum	**U.S.**	**Canada**	**Britain**	**Belgium**	**France**	**Germany**	**Italy**	**Netherlands**	**Switzerland**	**Japan**
Central Bank Discount Rate	12.00	16.50	13.7187 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.50	6.00	5.50
Day-to-Day Money	13.25 February 25	15.50	14.50	15.00	14.50	10.05	20.50	9.50	13.50	6.4375
Treasury Bills 91-day, Middle Rates	11.98 discount basis	14.40	13.375	14.25	n. a.	n. a.	19.302 90-days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	12.50 finance paper discount basis	14.65 finance paper 15% tax w/h	12.57	13.90 Certified	14.625 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.25	14.70 15% tax w/h	13.9375	13.90 Certified	not traded	9.90	22.60	no market	8.25	no market
Government Bonds Long-term, new and old issues, average yield	14.05	15.50	14.08	10.943 20% tax w/h	15.97	9.79*	20.66	10.89	5.52	7.57
Industrial Bonds prime, long-term, new and old issues, average yield	15.00 Aa Industrials	17.00	15.84	16.723	17.09	9.82*	20.46	11.73	6.35	7.18
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	16.50	15.00	18.00	15.95	14.00	22.50 ⅛ qtrly fee on outstdng.	12.00	10.5625	6.00
Bank Time Deposits 3-month	13.375 Cert. of Dep.	15.16	14.00	13.75	14.625	10.05	10.75	10.25 large deposits	8.00 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	15.00	no market	14.0625	no market	15.6875	10.25	no market	10.00	8.25	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8207	1.8955	.0232	.1658	.4228	.000788	.3853	.5336	.00427
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.049 *P*	1.14 *P*	.10 *D*	.0003 *D*	4.82 *P*	6.00 *D*	4.97 *P*	6.67 *P*	8.41 *P*

Eurodollar Deposits
(London, interbank, bid)
February 25

7-day	13.75
1-month	14.375
3-month	14.875
6-month	14.9375

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.351
U.S.-Canada Treasury Bills	−1.796
U.S.-Canada Finance Co. Paper	−1.998
Eurodollars-U.K. Local Auth. Deposits	+ .11

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.625
Over 7 yrs.	15.8125
DM Bonds	
7 yrs. and under	9.875
Over 7 yrs.	9.625

Gold Price
London
afternoon fixing

362.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of February 12, 1982.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Jan.) 8.4	(Jan.) 11.4	(Jan.) 12.0	(Dec.) 14.0	(Jan.) 6.3	(Jan.) 17.3	(Jan.) 6.1	(Dec.) 4.3
Industrial production*	(Jan.) −8.1	(Nov.) −2.9	(Dec.) −1.2	(Dec.) 0	(Dec.) 0.5	(Dec.) 0.1	n.a.	(Dec.) 4.3
Trade balance† *(billions of local currency units)*	(Dec.) −$1.59	(Dec.) C$0.75	(Dec.) £0.33	(Dec.) −FF7.93	(Jan.) DM1.11	(Dec.) −Lit.1,090	(Jan.) −SF0.24	(Dec.) ¥484
Money supply (M1)*	(Jan.) 7.3	(Dec.) −1.9	(Nov.) 10.7	(Oct.) 16.4	(Dec.) −0.9	(Oct.) 8.0	(Nov.) −7.2	(Nov.) 8.3
Velocity of money (M1)*	(Sept.) 10.7	(June) 6.7	(March) 4.1	n. a.	(Sept.) 5.1	(Sept.) 4.4	n. a.	(June) 2.7
Reserves minus gold *($ million, change from previous month)*	(Dec.) −930	(Dec.) −164	(Dec.) −327	(Dec.) 425	(Dec.) −926	(Dec.) 1,575	(Dec.) 3,550	(Dec.) −373

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

The Mexican Devaluation: Lessons from the Past

The de facto devaluation of the peso upon the announcement on February 18 that the Bank of Mexico would no longer support the currency in the foreign exchange market immediately conjured up memories of the 1976 peso devaluation—and of the debilitating economic events that followed. After a doubling of the peso/dollar rate in 1976, the Mexican economy lapsed into a period of market instability and upward price adjustment, followed by austere policies and slow growth. There are enough similarities between the economic environments contributing to the two devaluations to evoke feelings of *déjà vu* and concern for what the recent action implies for the Mexican economic outlook.

Since the peso established itself at a rate of 22 to 23 to the dollar after the 1976 action, Mexico has ostensibly conducted a managed floating-exchange-rate regime. In reality, however, this managed float has had properties of a fixed-rate system. The magnitude of the peso's recent devaluation against the dollar—over 40%—indicates how untenable this type of policy had become. In 1982 as in 1976, the decision to let the peso float was brought about by economic rather than political forces. In essence, the move represented an acknowledgement by the authorities that it was no longer economically viable to peg the exchange rate when the market was demanding an adjustment. Politically, the monetary authorities in Mexico, as in other countries, have the primary responsibility for exchange-rate management. Nevertheless, it is the aggregate supply and demand for a currency—inside a country and out—that determines its value, whether under fixed- or floating-exchange-rate systems.

In 1976, the Mexican devaluation occurred because there was a buildup of an excess supply of pesos. Within Mexico there was a strong desire to shift out of pesos and into dollars, and consequently, a heavy flow of capital out of the country took place. The recent devaluation occurred for much the same reason. Understanding the events leading up to and following that earlier devaluation should shed some light on the economic forces currently at work.

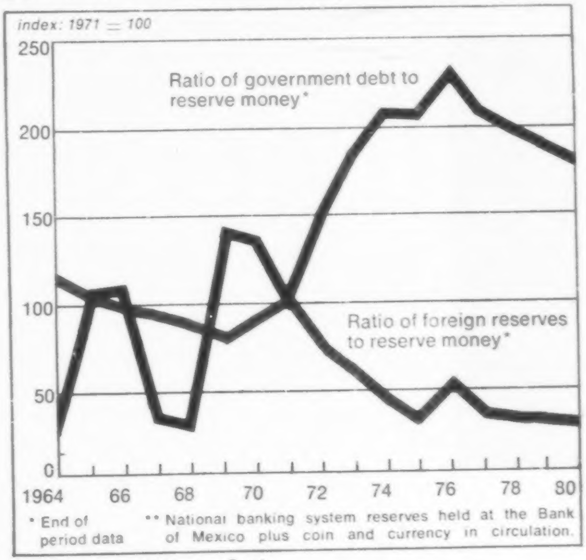
The history of the 1976 devaluation

Prior to the 1976 devaluation, Mexico essentially continued to operate as if it were in a fixed-exchange-rate world, despite the system of managed floating exchange rates that emerged after the breakdown of Bretton Woods in the early 1970s. At the same time, the country was being buffeted from the outside by worldwide inflation and from the inside by a fundamental change in economic policy that sent shocks throughout the Mexican monetary sector.

In the early part of the decade, the relatively expansionary monetary policies of the United States fed large flows of capital into the rest of the world. This created inflationary pressures, which the Mexican authorities attempted to reverse with a restrictive monetary stance in 1971. The government's anti-inflationary tactics proved to be ineffective, not only because the fixed exchange rates allowed the excess demand for money to be satisfied with dollars, but also because the political consequences of a tight domestic monetary policy could not long be tolerated. The restrictive measures had slowed economic growth much more rapidly than had been anticipated, and there were strong pressures for the adoption of a more stimulative policy. The government enacted expansionary expenditure and investment programs, but at the same time held fast to the inelastic fiscal revenue structure inherited from the development policies of the 1950s and 1960s. The result was a huge increase in the federal deficit. By 1975 federal government expenditures had risen 300% over the 1971 level and the deficit equaled about 5% of GDP. This presented the Mexican monetary authorities with a dilemma: The deficit had to be funded, either through expanded foreign borrowings, or domestically through increased debt to the private sector or by the stepped-up printing of pesos.

Much of the deficit was financed by foreign borrowing. But the bulk of the responsibility for financing

Sources of Reserve Money in Mexico**



Data: International Monetary Fund

(continued from page 7)

the deficit internally fell to the Mexican monetary authorities—indirectly through financial intermediaries or directly by money creation. Mexico had created an ingenious system for funding the public debt through reserve requirements on financial intermediaries during the 1960s, when these services were expanding rapidly. In the early 1970s, however, owing partly to the monetary authorities' lack of success in containing inflation and to an increasing awareness that the federal deficit could not be financed without additional money creation, this type of financing became more difficult. The rate of demand for savings by the private sector declined as portfolio adjustments were made to protect against higher inflation. Domestic savings decreased in real terms, shrinking the central bank's capacity for funding the deficit through financial intermediaries. And with capital flight beginning, this left money creation as the only alternative.

Domestic credit grew some 30% in 1973, accelerated to 40% growth in 1974, and by 1975 was expanding at an annual rate of 50%. This high growth in domestically created money was about double the rate of growth in demand for those funds, causing an excessive buildup in the supply of pesos. This created pressures that had to be relieved through an outflow of reserves, given Mexico's intent on maintaining a fixed exchange rate.

According to the principles of the monetary approach to international adjustment, the Mexican authorities could maintain a given exchange rate through an intervention policy, until they depleted their supply of the intervention currency—U.S. dollars. Throughout the 1950s and into the 1960s, the Mexican authorities consciously maintained the share of the monetary base denominated in dollars or gold at a high level. In 1958, for example, foreign assets were 55% of reserve (or base) money. In 1966, they were still at 40% of reserve money. By 1975, however, the ratio had fallen to only 14% (see chart, preceding page). Thus, the stage was set for a devaluation. If Mexico had been willing to accept a flexible exchange rate, the pressure of the excess supply of pesos on reserves would have been replaced by pressures on prices and/or the exchange rate, and there would have been no reason for reserves to flow out of the country. But the groundwork for a downward adjustment in the exchange rate had been laid over 1973-75. And as pressures began to mount, the public responded with capital flight. Given the environment, and given that the financing needs of the government had to be satisfied via an expansion of the domestic money supply, the Bank of Mexico was left with no other choice but to devalue.

The devaluation experience

The 1976 devaluation experience itself may include policy lessons applicable to Mexico in the near term. Following the de facto adjustment on September 1, 1976, the peso was floated for a period until it reached 19.5 pesos per dollar. At that rate the Bank of Mexico unilaterally repegged it. In doing so, it created an almost risk-free speculative situation, or in essence, provided Mexican citizens a vehicle to avoid another devaluation. The "dollarization" process then began. Citizens swapped pesos for dollars in their portfolios until eventually the Bank of Mexico depleted its reserves of dollars. The peso was once again floated, but by this time its "credibility" had been greatly damaged. It was some time before the rate stabilized in the 22-to-23-pesos-per-dollar range. In the interim there was an extended period of financial uncertainty and instability. This finally ended with assurances brought by the restrictive policies of the then-new President Lopez Portillo.

Although the lessons learned from the 1973-76 experience have not gone unheeded over the last few years, policy choices were made that ensured that the 1982 devaluation was inevitable. Fiscal deficits grew and had to be financed by money creation, which once again led to capital flight, dollarization, a decrease in the ratio of foreign assets to reserve money (down to 13% in 1980), and, within Mexico, an increasing belief that the peso was overvalued. This situation could not last indefinitely and the peso had to adjust. Now, almost six years later in the aftermath of another sizable devaluation, two questions arise: Will the peso experience another period of instability and uncertainty similar to late 1976? And will the government once again have to reinstate a tough monetary and fiscal policy in order to stabilize the peso?

The economic prospects for Mexico in 1983 and 1984, under a new president, will depend critically upon the policies that Mexico chooses to back this recent devaluation. Policy adjustments already in place will be tested as Mexican citizens attempt to protect themselves against inflation. Furthermore, policy adjustments must be keyed to controlling the creation of domestic credit—an intention of the authorities. This implies decreasing the fiscal demands upon the central bank to create that credit. This may not be an easy task. Nevertheless, the 1976 and 1982 devaluations have already provided two lessons that a stable peso and expansion of domestically created money are not consistent.

D. Sykes Wilford

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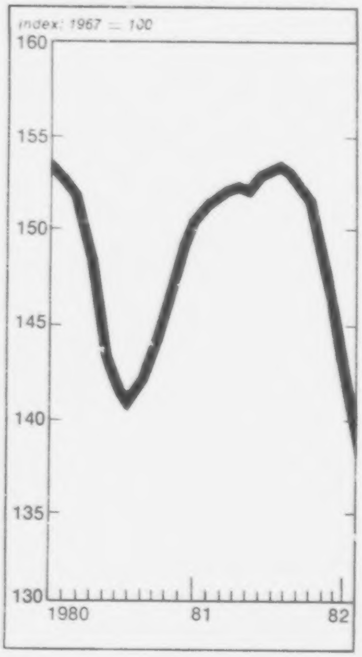
A Spring Recovery For the United States?

The U.S. recession is more than seven months old—already longer than the 1980 recession, but still several months under the average length of economic contractions since World War II. Statistical indications of future developments are mixed, as they generally are at this stage of a cycle. Nevertheless, there is an emerging consensus among economists that the cyclical low point will fall within the March-May period. There is much less agreement, however, on how vigorous or how long-lived the ensuing expansion will be.

Perhaps the most encouraging development has been the speed and vigor with which business has moved to get its inventories back into balance with the lower level of sales. The immediate effects of such a response are of course negative—a sharp decline in production (see chart), and a further cutback in employment and income. However, although these developments may be painful, they are a necessary part of the process that ultimately brings recessions to an end. Inventories were reduced, in real terms, in December, and cutbacks apparently have continued since then. In the past, the cyclical low point in the economy has generally been reached within a very few months after inventories began to decline. Other favorable signs include a modest downtrend in interest rates, and further abatement in the rate of price inflation. The Consumer Price Index has risen at an average annual rate of under 5% since last October. In the third quarter of last year the rate was over 12%.

U.S. industrial production



An economic upturn beginning in the spring months would probably be slow at first. But fiscal policy will provide a boost in July, when a cut in personal income taxes and a rise in Social Security retirement payments will add about $45 billion (or 2%) to incomes after taxes. That should speed up the pace of recovery. Alternatively, if the pessimists are correct and the recession continues until summer, the fiscal stimulus should help bring it to an end.

Even with an early upturn, U.S. economic growth will be modest this year—perhaps 1-1½%, year-end to year-end. And there is widespread concern that performance in 1983 might not be much better. The administration's projection for 1983 growth is 5.2%, which is four or five times the estimated growth for the previous three years combined. In private circles, there are fears that growth in 1983 may again be severely constrained by another rebound in interest rates, reflecting the combination of restrictive monetary policies and federal deficits that may remain stubbornly over $100 billion a year.

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German domestic economy remains depressed; recovery hopes hinge on export performance.

Despite relatively strong export growth, Germany's domestic economy is continuing to weaken. Seasonally adjusted real GNP fell at an annualized rate of some 0.7% in the fourth quarter, even though export volume rose at an annual rate of 12%. The decline in real domestic demand was led by fixed investment, which fell 13%. The volume of domestic industrial orders was down 8% in the final quarter of 1981, and recent numbers fail to show an upturn. This poor performance, together with the continuing high level of real interest rates, is leading economists to revise down their growth forecasts for 1982—despite a provisional report that showed industrial production rose in January. Domestic demand now seems likely, at best, to remain flat, at worst, to decline by some 2%. The hope of positive real growth this year hinges on export performance, which should remain strong through the first half of 1982, but, in the absence of an early recovery in the rest of Europe, looks increasingly vulnerable in the second half of the year.

Devaluation first step in Belgian recovery program, real wage cuts must come next.

Following last month's loosening of wage indexation, the Belgian authorities devalued the central rate of the Belgian franc against the German mark by 8.5%. The devaluation was accompanied by a one-month price freeze, cuts in electricity and gas tariffs to reduce industrial costs, and additional investment incentives. This package, together with earlier measures to shrink Belgium's large public sector deficit, has allowed the franc to remain within its new band against other currencies in the European Monetary System, thus giving the authorities room to reduce interest rates. The ultimate success of the devaluation, however, depends on the authorities' ability to reduce real wages. Although the 3% cut currently envisaged should help to improve export competitiveness, it will not be sufficient to overcome the competitive disadvantage suffered by Belgian exports since the mid 1970s.

Inflation and balance-of-payments problems continue to plague Portuguese economy.

Portugal's crippling drought of 1981 has finally ended. However, the resurgence of domestic labor unrest serves as a reminder to the authorities of the economic problems they still face. Consumer price inflation now stands at a year-on-year level of 23.7% after an acceleration in the second half of 1981. This, together with a tight 1982 budget, has put a squeeze on real wages and consumer spending. Meanwhile, the balance-of-payments performance offers only minimal relief. In the first three quarters of 1981, the current-account deficit was $1.87 billion, more than double the deficit over the same period for 1980. Depressed EEC markets offer only limited opportunities for an early export recovery, despite the December increase in the monthly crawling peg devaluation rate. However, the soft oil market and the expectation of a "normal" year of rainfall should be sufficient to reduce the 1982 current-account deficit to below $2 billion.

Caribbean Basin aid/trade programs could set stage for economic revitalization.

President Reagan's Caribbean Basin Initiative announced last month could help lay the groundwork for revitalizing a region beset with political and economic problems. The U.S. president's plan, unveiled at the February meeting of the Organization of American States, includes a series of interrelated trade, investment, tax, credit, and financial assistance measures designed to stimulate economic development for nearly two dozen countries in Central America, northern South America, and the Caribbean. Complementary programs have been put forth by Canada, Mexico, and Venezuela. A key component of the U.S. initiative is a 12-year "free-trade" arrangement, whereby imports from the Caribbean Basin to the United States would be duty free. (Exceptions would be made for imports of certain textile and apparel products which are controlled by the international Multifiber Agreement.) The hope is that the lifting of import duties, combined with other proposed investment tax incentives and increased guarantees for trade credits to the region, will spur private sector investment.

Mr. Reagan has also proposed increasing direct U.S. economic assistance to the Caribbean Basin countries to a total of $824 million for fiscal 1982. The results of the aid plan are likely to be neither quick nor dramatic over the near term. Much of the program requires approval of the U.S. Congress. And the recipient countries must be prepared to respond to the initiatives. Nevertheless, a beginning has been made, and if approved and implemented vigorously it could represent a positive opportunity for the Caribbean Basin countries to achieve sustained economic progress over the long run.

Colombian authorities adopt new credit measures to stimulate economy.

The Colombian government has taken a series of monetary measures to stimulate the economy after last year's slow growth. Real GDP advanced by only 3%-3.5% in 1981 and business complained about high domestic interest rates. The recent policy adjustments are designed to add additional liquidity in the economy and ease the pressures on interest rates. One of the most critical of the new monetary steps taken is the central bank's "unfreezing" of 5.5 billion pesos for specific use in agricultural, industrial, and electrical projects. Equally important, the authorities have reduced prior import deposits for raw materials and consumer goods to 20% from 35% and eliminated the deposit on capital goods. Internationally, the authorization for foreign loans has been liberalized by increasing the number of eligible borrowers. Previously, such loans had been limited to a few lines of activity. Although some concerns have been expressed that monetary stimulation might push up last year's 28% inflation rate, careful economic management should permit some increase in economic growth without excessive price pressures.

Recovery likely to be slow for weak Australian dollar.

The Australian dollar's recent weakness reflects not only the strength of the U.S. dollar against other major currencies, but also the deterioration of Australia's balance of payments over the last year. Continued labor disputes and the uncertainties regarding the long-term demand outlook, dampened last year's resource boom considerably. Foreign investment inflows, as a result, slowed from $4.1 billion in the first half of 1981 to only $3.1 billion in the second half, and the current-account deficit widened to $4.4 billion from $3 billion. There was, however, one positive effect. The resulting deficit in the overall balance of payments—by soaking up domestic liquidity—actually helped maintain tight monetary control, which, in turn, kept potential wage pressures in check. At the moment, farmers and exporters are demanding further devaluation, but the government is resisting such action for fear of fueling inflation. The Australian dollar by now may have just about hit bottom. Its recovery, however, is likely to be slow, depending on the course of the world economy and U.S. interest rates.

Sri Lanka maintaining tight rein on government budget.

The government of Sri Lanka last year showed considerable improvement over 1980 in keeping its budget in line. The overall budget deficit is estimated to have been 12.5 billion rupees—actually slightly less than the revised budget target of Rs. 12.7 billion. And bank borrowing for deficit financing is estimated to have been contained at Rs. 3.8 billion, relatively close to the figure budgeted and down sharply from 1980's Rs. 7.2 billion. The 1982 budget calls for a sharp increase in capital expenditures as the Mahaweli-Ganga Development Project picks up steam. To hold the budget deficit to Rs. 18.4 billion, new tax initiatives have been undertaken. With a sharp increase in foreign aid, much of which has already been committed, bank borrowing for deficit financing is to be held at Rs. 2.97 billion or an estimated 2% of GDP. The budget clearly is tight. Actual aid disbursements could easily fall short of projections. Moreover, the government must also act to pass along increases in international prices in order to hold down subsidies and costs. Still, the 1982 budget seems to be one of the more responsible budgets prepared by the government in recent years.

Market Yield Spreads Widening

Over the past few weeks, the fixed-income securities markets have witnessed a significant widening of yield spreads between instruments of the same maturity, not only between corporate and government securities, but between different kinds of corporate bonds, as well. Among instruments of three-month maturities, for example, the spread between prime commercial paper and Treasury bills has risen to 135 basis points—substantially higher than the 80-basis-point spread averaged over the 1970s. Moreover, in the longer-term markets, A-rated corporate industrial bonds currently yield over a full percentage point higher than AAA bonds of the same maturity, which, in turn, are about 80 basis points higher than comparable Treasury bonds. These spreads compare with average yield differentials of only 50 and 25 basis points, respectively for the 1970s.

Yield differentials generally exist for a variety of reasons. Differences in the default risk associated with the issuers of the instruments are a major determinant, although the market supply-demand conditions for individual securities also play an important role. For instance, the financing needs of a particular issuer or investor perceptions of the problems in a specific industry can cause wider yield spreads between securities of similar default risk. In addition, different characteristics of the securities, such as call features and size of coupon payments, also affect yield spreads.

For the most part, the current spreads reflect investors' concerns about the state of the economy and the financial difficulties of the issuers. Typically, as the trough of a recession approaches, the default risk associated with corporate debt instruments rises as profits decline and some over-leveraged firms experience trouble in covering their interest payments. On average, this increased risk manifests itself in higher interest rates on corporate instruments (commercial paper and bonds) relative to default-free government obligations of comparable maturity.

Similarly, the spreads among corporate bonds of different quality ratings widen during recessionary periods. Although lower-rated bonds always carry higher yields than higher-rated bonds, the significance of the rating difference grows as the market perceives a greater risk of default in the poorer-performing firms.

Despite these recent developments in yield structures, however, it is useful to compare the current spreads to their magnitudes in 1981. Although spreads are currently wider than they were a month ago, they were significantly wider still during last year. There are two possible explanations for this: Corporate securities may have lower yields relative to Treasury debt, because the adverse impact of the recession on

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE			
			6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered
Africa	**Algeria**	French companies awarded several project contracts following agreement on gas prices.	Nov.	−21%	36.0	1,935	Jan.	3,590	− 2%	4.5
	Cameroon	Fuel and pulpwood production to be expanded with aid of $17-million World Bank loan.	Mar. '81	+ 6%	6.5	790	Sept.	95	− 52%	0.5
	Egypt	Foreign direct investment in petroleum sector rising; several new oil finds announced.	Sept.	+ 4%	22.7	535	Nov.	1,230	+ 16%	1.7
	Gabon	National budget for 1982 curbs spending, emphasizes productive investment.	Dec. '81	0	3.6	6,545	Sept.	194	+123%	1.3
	Guinea-Conakry	U.S. Steel Company to take key role in developing Mifergui-Nimba iron ore project.	Dec. '80	+11%	1.5	270	n. a.	—	—	—
	Liberia	Economy stagnates; only agriculture shows modest growth.	Nov.	−11%	1.1	570	Nov.	8	− 11%	0.2
	Libya	Development outlays to be cut 5% in 1982 owing to drop in oil revenues.	Nov.	−50%	23.0	8,050	Dec.	9,003	− 31%	8.6
	Morocco	Foreign investors to be allowed full ownership of local companies.	Sept.	+ 1%	18.1	896	Dec.	230	− 42%	0.6
	Nigeria	Economic growth continues somewhat dampened owing to lower oil output.	Nov.	−42%	78.0	1,013	Dec.	3,894	− 62%	2.5
	Senegal	Dakar free industrial zone gained seven new plants in 1981, creating 900 new jobs.	Dec.	− 9%	2.5	437	Nov.	6	− 52%	0.1
	South Africa	General sales tax raised to 5% from 4% as budget deficit widens.	Dec.	−26%	76.7	2,618	Jan.	588	− 37%	0.3
	Tanzania	Shortages of parts and materials reduce manufacturing sector output to 30% of capacity.	June	+ 5%	6.0	325	Nov.	23	− 53%	0.2
	Tunisia	Government spending on development projects rising.	Oct.	+13%	8.6	1,350	Jan.	596	+ 13%	1.9
	Zimbabwe	Severe drought may halve maize harvest; cotton, tobacco, wheat, and livestock also affected.	Dec.	− 5%	4.8	645	Aug.	220	− 30%	1.7
Middle East	**Kuwait**	Major contract awards for new development projects totalled $3.6 billion in 1981.	Nov.	−15%	27.3	19,870	Jan.	4,023*	0%	7.3
	Qatar	Gas production shortfalls delay plans to increase domestic petrochemical output.	Nov.	−15%	5.0	23,100	Sept.	347*	− 10%	3.5
	Saudi Arabia	Pace of development outlays continues strong.	Nov.	+ 9%	117.6	14,050	Jan.	32,675*	+ 39%	12.6
	United Arab Emirates	Federal expenditures rising with development of power projects.	Nov.	− 4%	19.4	23,000	Jan.	3,104*	+ 29%	4.4

*Excluding state reserves.

corporate profits, in the market's estimation, may be less severe than was expected during 1981. An alternative explanation, however, is that Treasury yields have risen relative to corporate yields, because of investor uncertainty about the federal deficit. The large supply of government debt expected to be brought to market could be putting upward pressure on Treasury yields, keeping the corporate-government spread narrow relative to last year's experience.

Not all wider yield spreads are reflections of a general deterioration in economic activity, however. Yield differentials between debt instruments of issuers in different industries may be influenced by the particular circumstances of those industries. For example, the yield on AAA utility bonds is currently a relatively large 125 basis points higher than the yield on similar industrial bonds. This premium on utility bonds is probably due to investor uncertainty over the outlook for electric and communication utilities. Prospects for future energy costs and the feasibility of nuclear power plant construction, as well as the future organization of the telephone industry, are sources of concern which manifest themselves as industry risk premiums.

Other yield spreads arise from differences in the characteristics of the bonds. Two of the most important of these are the size of coupon payments and call provisions. The size of coupon payments is always a significant determinant of yield spreads, and higher-coupon bonds usually have higher yields than lower-coupon bonds. For instance, seasoned AAA long-term industrial bonds that carry a 10% coupon currently yield 90 basis points over comparable 7¾% coupon bonds. This premium is related to the differential tax treatment for ordinary interest income and capital gains. Since lower-coupon bonds return a larger proportion of their yield in the form of capital gains, their earnings are taxed at a lower average rate. Because of this advantage, their before-tax yield is generally lower than otherwise-equivalent, higher-coupon bonds.

Even without considering this tax-related issue, however, the size of the coupon payment plays an important role in conjunction with call provisions. Since a call provision enables the corporation to retire the bonds at a specified price prior to maturity, callable bonds always carry a premium over non-callable bonds of similar rating and maturity. This premium increases, however, when market participants anticipate a greater likelihood that the call provision will be exercised—namely, when they expect interest rates to fall. Moreover, the premium is larger for higher-coupon bonds than for lower-coupon bonds, since it is reasonable for corporations to place a priority on retiring their most costly debt obligations earlier. The fact that there now exist examples of callable bonds of equal rating and maturity for which the spread between the higher-coupon and lower-coupon bond has increased also suggests that many investors are anticipating a decline in interest rates.

Carl Alan Batlin

PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				exchange rate in U.S. dollars	change from year earlier		
IMF mil-dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	March 10, 1982		current monetary conditions	
0	Oil output in 1981 averaged 808,000 b/d, down 21% from year earlier.	Dec. '79	+12%	July	+17%	.2270	− 9%	Foreign exchange reserves held steady through January.	Algeria
4	Higher oil output points to $800-million surplus on 1981 oil account.	Aug.	+ 9%	Sept.	+22%	.00332	−19%	Credit extremely tight.	Cameroon
8	Light crude oil price cut $1 for second time since early February.	Sept.	+ 7%	Nov.	+15%	1.21	−17%	Money supply growing more rapidly.	Egypt
3	ECGD sets up $10-million credit line at 8.5% to fund British exports to Gabon.	May	+ 3%	Sept.	+14%	.00332	−17%	Credit relatively easy.	Gabon
0	Low aluminium price dampens 1982 export earnings outlook.	n. a.	—	—	—	.0585	n. a.	Saudis to back three new financial institutions.	Guinea-Conakry
0	Exports continue weak owing to sluggish rubber and iron ore demand.	Oct.	+10%	Oct.	−10%	Par	0	Credit to private sector contracts.	Liberia
0	Oil output averaged 1.1 million b/d in 1981, down 39% from year ago.	n. a.	—	Dec.'79	+33%	3.4050	0	Expansion of money supply slowing.	Libya
4	Phosphate production was 22.2 million tons last year, up 6.7% from 1980.	Oct.	+23%	Oct.	+ 9%	.1870	−13%	Local bank (BNDE) raises $52 million Euroloan.	Morocco
0	Feb. oil output down to 1.45 million b/d, vs. 1.8 million in Dec. and Jan.	June	+24%	July	+32%	1.5269	−15%	Value of naira now being adjusted almost daily.	Nigeria
5	Bumper groundnut crop forecast for 1981/82; cotton also looks good.	Sept.	+ 9%	Sept.	− 2%	.00332	−18%	Liquidity continues very tight.	Senegal
0	New 10% surcharge affects 40% of all imports.	Dec.	+14%	Nov.	+32%	.9900	−22%	Short-term foreign borrowings increase sharply.	South Africa
7	Arrears on import payments estimated at over $270 million.	Jan. '81	+30%	Mar.	+27%	.1210	− 1%	Resistance to currency devaluation continues.	Tanzania
0	Jan.-Oct. 1981 trade deficit was $1.2 billion, up 40% from year earlier.	Oct.	+10%	Nov.	+23%	1.9180	−18%	France taking 30% share in new investment bank.	Tunisia
36	Delivery of locomotives will ease transportation problem.	Dec.	+20%	Dec.	+16%	1.3870	−11%	Foreign exchange shortage continues.	Zimbabwe
0	Oil output down to 600,000 b/d, well below 1.25 million b/d official ceiling.	Dec.	+ 8%	Nov.	+51%	3.5220	− 3%	Activity increasing in domestic bond market.	Kuwait
0	Oil output averaged 405,000 b/d last year, down 14% from 1980.	n. a.	—	Sept.	+17%	.2975	+ 8%	Private sector credit expanding more slowly.	Qatar
0	Aramco output now at 7-7.5 million b/d, vs. 9.6 million average in 1980-81.	June	+ 2%	Sept.	+17%	.2930	− 2%	Money supply growth accelerates.	Saudi Arabia
0	Abu Dhabi's 1981 oil output averaged 1.13 million b/d, 16% below 1980.	n. a.	—	Nov.	+25%	.2730	0	Credit to private sector rising steadily.	United Arab Emirates

World Interest Rates

market rates of March 10, 1982; bond yields as of March 5, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	15.12	13.5625 intervention rate	13.00	9.50	7.50	19.00 penalty rate 22.00	8.50	6.00	5.50
Day-to-Day Money	14.50 March 11	15.12	14.50	12.50	14.25	10.00	20.375	9.625	4.00	6.625
Treasury Bills 91-day, Middle Rates	12.45 discount basis	14.75	12.625	13.75	15.485	n. a.	18.25 90-days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	13.50 finance paper discount basis	15.60 finance paper 15% tax w/h	12.09	12.90 Certified	14.25 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.65	15.55 15% tax w/h	12.5625	12.90 Certified	not traded	9.40	22.25	no market	6.50	no market
Government Bonds Long-term, new and old issues, average yield	13.40	15.50	13.58	10.7355 20% tax w/h	16.04	9.68	20.03	10.61	5.42	7.25
Industrial Bonds prime, long-term, new and old issues, average yield	14.40 Aa Industrials	17.00	14.99	15.368	17.04	9.63	20.41	11.42	6.25	7.10
Bank Short-Term Rate to Best Borrowers (prime rate)	16.00	16.50	14.50	17.00	15.95	13.50	21.75 ⅛ qtrly fee on outstdng.	11.50	8.00	6.00
Bank Time Deposits 3-month	13.80 Cert. of Dep.	15.68	13.375	13.45	14.25	9.95	10.75	9.50 large deposits	6.00 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	14.7500	no market	13.50	no market	15.625	9.5625	no market	9.50	6.8125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8256	1.8160	.0228	.1658	.4249	.000786	.3859	.5394	.00422
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	0.970 *D*	1.54 *P*	.647 *P*	.970 *P*	5.391 *P*	5.612 *D*	5.391 *P*	8.052 *P*	8.381 *P*

Eurodollar Deposits

(London, interbank, bid)
March 11

7-day	14.75
1-month	14.75
3-month	14.875
6-month	14.875

International Arbitrage

(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.541
U.S.-Canada Treasury Bills	− .6238
U.S.-Canada Finance Co. Paper	− .916
Eurodollars-U.K. Local Auth. Deposits	− .1025

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	14.50
Over 7 yrs.	14.75
DM Bonds	
7 yrs. and under	9.85
Over 7 yrs.	9.80

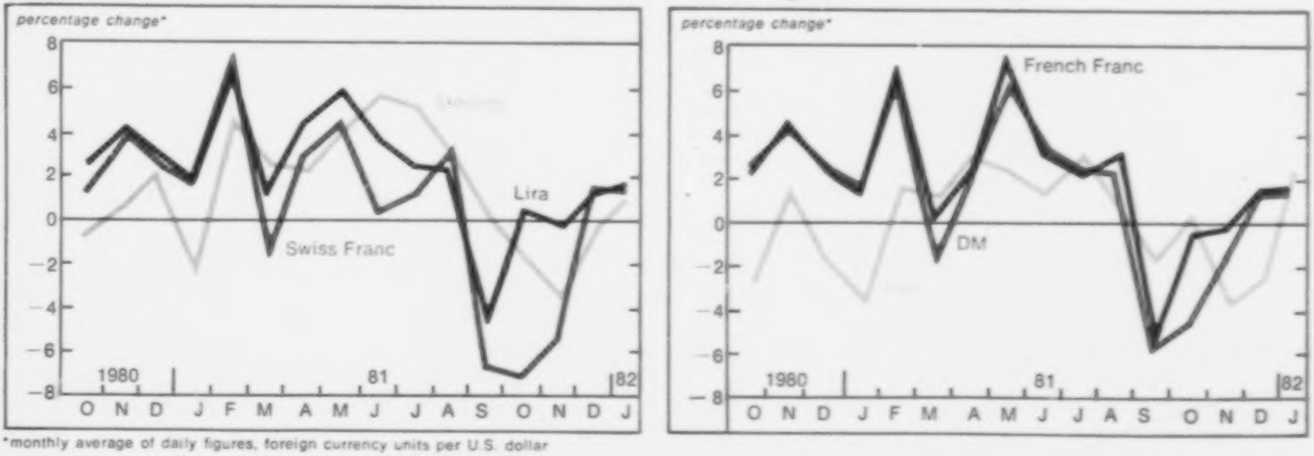
Gold Price

London
afternoon fixing

333.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Movements of major currencies against the dollar



*monthly average of daily figures, foreign currency units per U.S. dollar

Troubles Plague Sudanese Economy

Although optimism still surrounds Sudan's enormous oil potential, a formidable array of problems continues to threaten the country's tottering economy. The largest country in Africa in geographic area, Sudan is unable to feed itself or pay for its food imports. Its infrastructure is grossly inadequate and it is losing desperately needed skilled and semi-skilled workers to higher-paying OPEC nations. Hopes for the virtually bankrupt country's future rest on significantly increased Arab investment—currently not very likely because of the recent decline in oil earnings—and on early exploitation of its petroleum resources.

Standard Oil Co. of California recently estimated that Sudan's probable reserves are as high as 10 billion barrels. If so, that would move Sudan to 14th place in terms of oil deposits, ahead of Indonesia and Algeria. By late 1982, over one-third of Sudan's land area—or 80% of available concession areas—will be under exploration. Sudan's oil is reported to be of excellent quality.

Sudan has a 26,000 b/d refinery at Port Sudan on the Red Sea, and a 25,000 b/d refinery south of Khartoum, at Kosti, is planned. Although slated to come on-stream in 1983 with initial capacity of 15,000 b/d, the Kosti refinery most likely will not be completed until 1986 because of financial problems. No date has been set for oil self-sufficiency and oil exports are not yet contemplated. There would have to be proven reserves of at least a billion barrels before it would be economically justifiable to invest an estimated $3 billion in an export terminal and a pipeline to the coast.

The payments squeeze

Ironically, spiraling oil bills that swallowed vital foreign exchange helped push Sudan to the economic precipice in the late 1970s. Even more important were overly ambitious development plans aimed at making Sudan the breadbasket of the Middle East and the slow growth of export revenues—owing primarily to lagging earnings from cotton.

The latest IMF-inspired austerity package, adopted by Sudan late last year, seeks to revitalize the economy and win back the international financial community's confidence. The domestically unpopular measures included devaluation of the Sudanese pound, abolition of the two-tier exchange rate system, and discontinuation of subsidies on essential consumer goods, such as gasoline, sugar, wheat, and flour. The program is aimed at decreasing import expenditures, encouraging remittance of expatriates' foreign currency earnings, and providing incentives to agricultural producers.

In particular, Sudan hopes to lure farmers back into cotton production. Although declining in importance, cotton remains its chief export earner, accounting for 36% of total export receipts in 1980/81, down from over 50% in the second half of the 1970s. In 1980/81, a decline in planting, along with pest problems and a lack of rainfall, contributed to a 22% drop in cotton production. Combined with sharply lower world prices, this almost halved Sudan's export receipts. The projected supply-demand picture implies continued price weakening until the world economy improves. In the long run, the main price determinant will be the rising world demand for food and the consequent pressure on cotton acreage.

The decline in cotton plantings, caused mainly by an inappropriate pattern of incentives and crop distribution, has wreaked havoc on Sudan's export performance. Total exports have been stagnating in the $500-600 million range since 1976/77 and fell below $500 million in 1980/81. Since 1975, the value of imports has been more than double that of exports, owing to sharply rising oil prices and development expenditures. The cost of oil imports alone rose from $90 million in 1975/76 to $400 million in 1980/81—a quarter of total imports. The recent foreign exchange moves, coupled with lower sugar imports as domestic production has expanded, should contain overall 1981/82 imports at about the previous year's level. The trade deficit, which reached $1.14 billion in 1980/81, should therefore narrow in 1981/82 if exports return to the level of recent years. However, the negative balance on the services account will deteriorate further as interest payments on the foreign debt rise significantly. Transfers, on the other hand, are expected to record another net positive inflow of around $450 million. This should prevent an increase in the overall current-account deficit, which, after ranging between $400-500 million during 1975-80, has widened to close to $800 million.

Sudan's inability to attract sufficient capital inflows led to payments arrears that reached $1.2 billion by 1979. Reschedulings of foreign debt since then have left these arrears at an estimated $1.0 billion at the end of 1981. Fresh injections of foreign capital will come from a just-approved $224-million IMF loan, another $75 million from commercial banks, and emergency bilateral aid. And this week, Sudan is expected to seek rescheduling of its official debt through the Paris Club.

But real GDP growth, which has been averaging a negative 1% since 1978, is unlikely to turn more than marginally positive in the near term. Inflation, which was still running at 25%-30% last October, is likely to come under further upward pressures from the withdrawal of subsidies and the currency devaluation.

Sudan's problems, however, do not stop at the economic frontier. Uneasy Arab alliances, threats from Libya, and absorption of refugees from Uganda and Ethiopia complicate political uncertainties at home.

Wally V. Koch

Financial Volatility and Policy Choices

For the last several years, the increased volatility in international financial markets has stemmed, in large part, from the erratic growth of the U.S. money supply and its commensurate influence on U.S. interest rates. Given the strong prospects that the U.S.-induced volatility is not likely to subside during 1982, authorities abroad will continue to face critical policy choices concerning how to manage their financial markets in this volatile environment.

Because the world financial markets are linked in a myriad of ways, markets in one country cannot be completely isolated from the shocks received by nor the volatility present in the world system. Policymakers in each country, however, can and do choose to direct the volatility through certain financial channels rather than others. That is, authorities to a large extent have some control over how market disturbances are transmitted to their own economy.

To clarify the policy choices facing authorities abroad in the current environment of widely fluctuating U.S. interest rates, it is useful to distinguish between two mechanisms that transmit financial disturbances: the process of arbitrage—which links domestic financial markets through the foreign exchange market—and fundamental shifts in domestic policy. This distinction is important in that for arbitrage, cause—or the economic event that sets off the process—is unimportant. For disturbances transmitted by policy shifts, however, cause is all important: economic variables are affected worldwide.

The arbitrage mechanism rests on an important principle: interest-rate parity. Interest-rate parity equates the return on a financial investment in one market—say the 90-day Eurodollar rate—with the return on an equivalent foreign-currency investment—say the return on 90-day Euro-German marks, which is covered by a 90-day DM/dollar forward foreign exchange contract. Thus, the differential between the two interest rates equals the forward foreign exchange premium (or discount).

International financial institutions risklessly arbitrage the interest-rate parity relationship. As a result, it is a relationship that is very tight—it always holds. Consequently, the implications for volatility are equally tight. If one part of the equation, say the Eurodollar interest rate, is highly volatile, then either: foreign interest rates are also volatile, or exchange rates are volatile, or both. The critical point, however, is that the source of the volatility is not important. Arbitrage and interest-rate parity are two-way streets.

On the other hand, with fundamental policy shifts, causality is of primary importance. For example, if the current volatility in U.S. interest rates is the result of anti-inflationary U.S. monetary policy, then the U.S. policy will force authorities abroad either to follow a similarly restrictive policy, or to acquiesce to increased volatility in exchange rates and domestic interest rates through the arbitrage relationship. Furthermore, if foreign monetary authorities pursue a less stringent anti-inflationary policy than the United States, they suffer the economic consequences of a depreciating currency in the foreign exchange markets.

Thus, policymakers abroad currently face two decisions: (1) they must either match the anti-inflation posture of U.S. policy or allow their currencies to depreciate against the dollar, and (2) they must choose the channel of volatility—either through exchange rates or interest rates. So far, most countries have decided not to match U.S. policy, and have allowed their currencies to depreciate. They have also chosen to minimize domestic interest-rate volatility at the expense of volatility in foreign exchange markets.

W. Dayle Nattress
Bluford H. Putnam

Quarterly Euromarket Report

($ billion, end of period)

Total Market Size	IVQ/80	IQ/81	IIQ/81	IIIQ/81	1979	1980	1981
Gross Size (Claims)	1,321.9	1,349.6	1,346.7	1,422.8	1,110.0	1,321.9	1,500.0
Net Size (Claims)	810.0	820.0	825.0	875.0	665.0	810.0	925.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	287.5	290.3	286.8	292.8	269.7	287.5	315.0
Liabilities to Private Nonbank Foreigners	75.0	80.9	83.6	90.6	65.9	75.0	95.0
Total Claims on Foreigners	385.4	394.1	405.9	421.9	324.2	385.4	435.0
Claims on Foreign Public Borrowers	48.9	50.1	50.7	54.9	42.0	48.9	57.0
Claims on Foreign Private Nonbank Borrowers	139.9	142.8	145.3	148.6	117.8	139.9	155.0

Note: Gross and net Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches. Source: Chase Manhattan Bank estimates based on BIS and national data sources.

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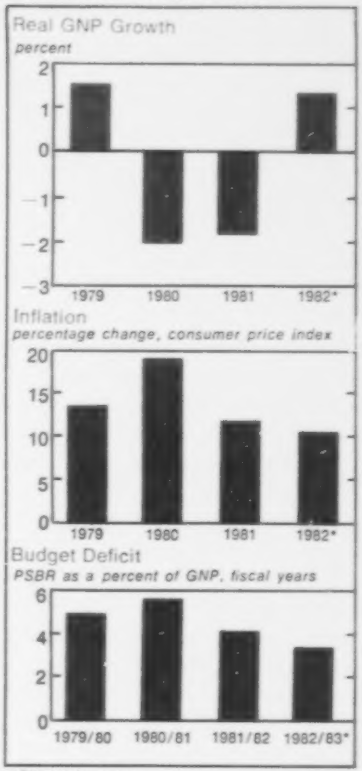
British Economic Policy Back on Course

Britain's budget for the upcoming fiscal year reaffirms the Thatcher government's commitment to the long-term strategy announced soon after coming to office in 1979. The unexpected depth of the U.K. recession had forced considerable deviation from the government's stated policy intentions. Based on this, some observers were predicting that the prospect of an election by 1984 would force the government to abandon its strategy completely this year and go for more traditional vote-catching policies. This has not happened. Instead, now that the recession seems to have come to an end, the government is returning to the original course set forth in 1979—albeit from a new starting point.

The new budget provides for some modest tax relief: Employers contributions to national insurance have been cut by 1%, and individual income tax allowances have been boosted by 14%—even more than the 12% increase equivalent to last year's inflation rate that the law requires. Part of the lost revenue will be made up from increased taxes on autos, cigarettes, and alcohol, but the overall tax take has been reduced from pre-budget levels. In addition, government expenditures are set to fall over the year and this will help bring down the deficit, or Public Sector Borrowing Requirement (PSBR), to £9.5 billion, or about 3.5% of GDP—significantly below the £10.5 billion PSBR for the fiscal year just ending and the £13.2 billion for fiscal 1980/81. The government has also restated its intention to hold the growth of the money stock within an 8%-12% band in the coming year. In addition, however, the policymakers have increased their maneuvering room by applying this target to three different measures of the money supply instead of just to sterling M3. The presumption—as yet to be put to the test—is that any overshooting by only one of the three would be ignored.

Selected U.K. economic indicators



* Official forecast

The government now expects some 1.4% growth in real GDP in 1982 and predicts the inflation rate will fall to 9% by year end. The implied 10.4% rise in nominal GDP for the year gives some hope that the money supply can be held within its target. Moreover, signs look promising that British interest rates will continue their recent downtrend. A major uncertainty for the interest rate outlook, however, is the world price for oil and its influence on the pound's exchange rate. The government has made it clear that it does not want to see any major sterling decline. And should the pound come under pressure, domestic interest rates would almost certainly be raised to defend it.

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French reflation policy may come under pressure as inflation and payments problems emerge.

The French economy slacked off considerably in the fourth quarter. Provisional figures indicate real GDP growth slowed to an annual rate of only 0.4%, bringing real growth for 1981 as a whole to 0.7%, despite robust consumer spending and strong export performance over the first half of the year. The current stance on fiscal and monetary policy remains reflationary, suggesting the economy may rebound in 1982 back toward the official target of 3% real GDP growth. However, there are signs emerging that the longer-term outlook may be somewhat less healthy. Government attempts to secure voluntary wage restraint have so far met with little success. And this may eventually undermine the aims of current policy as reflation leads to inflation and balance-of-payments difficulties. The trade deficit has already doubled in the past six months and the current-account gap in 1982 may expand to almost twice the 40 billion French franc deficit recorded in 1981. The current pace of monetary growth suggests that inflation—still at 13%—could become even more troublesome. Increasing evidence of these problems is likely to place selling pressure on the franc and may force some partial retrenchment in policy later on.

Austrian economy continues sluggish; recovery tied to export strength.

Similar to most of its European neighbors, Austria's domestic economy has remained lackluster. The latest data show that real GDP remained flat in the third quarter, as a 1.8% decline in domestic demand was offset by a 6.3% rise in export volume. Real GDP for 1981 as a whole is expected to have remained unchanged. And consumer prices showed an average rise of 6.8%—still high by historical standards. As a result of the economy's poor performance, seasonally adjusted unemployment rose to an all-time high of almost 120,000 in December, some 4% of the workforce. The net budget deficit in 1981 amounted to some 27.5 billion schillings, about 2.6% of GDP. The 1982 budget deficit is now expected to rise to 31.6 billion schillings, some 2.8% of GDP. Hopes of a 2% rise in real growth in 1982 are pinned on continued strong growth in exports, which will be made possible by a substantial rise in Austria's export competitiveness but will nonetheless remain dependent on an upturn in the economies of its trading partners in the second half of 1982.

Greenland votes to withdraw from EEC.

Negotiations are likely to begin soon on the withdrawal of Greenland from the European Economic Community. As a Danish province, the island had been taken into the Common Market in 1973, when Denmark joined, despite strong local opposition. Now more autonomous, Greenlanders last month, by a relatively narrow margin, voted to end their EEC affiliation. It now seems inevitable that the local parliament will ask the Danish government to arrange the terms of the withdrawal. The move is unlikely to alter Greenland's economic situation to any great extent, at least in the short run, as negotiations will probably last for more than a year. The longer-term impact is less certain. In return for giving EEC fishing boats free access to its waters, Greenland now receives about $22 million annually in EEC aid. If it leaves the Community, however, Greenland will be able to charge the EEC for fishing rights to offset the loss of economic assistance. In the end, the ice-bound province may well fall into the same category as some of the small French colonies that have especially favorable arrangements with the EEC while remaining non-members.

Banking reform could significantly alter Japanese financial structure.

Japan's new banking law scheduled to become effective April 1 could set the stage for substantial changes in the structure of the Japanese financial markets. Among its many reforms, the new law is expected to expand the market for national bonds and limit potential underwriting losses by providing for the direct sale of bonds to the public at bank teller windows beginning April 1, 1983. Currently, the government pressures syndicates of financial institutions to underwrite new issues of national bonds at below-market yields. Banks now risk onerous capital losses, particularly when market rates are rising, if they are forced to sell the bonds in the secondary market. Banks anticipate that under the new law, however, the bonds could be sold over the counter to individuals at a price closer to their purchase price, since the issuing rates on the bonds would be higher than the rate available on savings deposits. The new law also includes a provision allowing Japanese banks and securities firms to buy and sell domestically commercial paper and certificates of deposit issued abroad. However, capital outflow is likely to result as investors adjust their portfolios to take advantage of the new opportunities. And in anticipation of this effect, Japanese authorities just last week announced the postponement of the permission to sell foreign CDs and commercial paper—presumably at least until the yen strengthens.

Hong Kong's new "supply-side" policies include focus on international finance.

The Hong Kong government's announced budget for fiscal 1982-83, which begins April 1, includes a number of "supply-side"-oriented policies such as reduced growth of government spending and tax cuts for individuals and businesses. Of particular interest, however, are tax measures specifically directed toward boosting Hong Kong's position as an international financial center. Foreign-currency deposits were exempted from tax on interest, and for Hong Kong dollar deposits, the tax was cut to 10% from 15%. The authorities are hoping these changes will help attract foreign exchange trading business from abroad without causing a shift from local to foreign currencies in the domestic money market. The government is still projecting a budget surplus for the upcoming fiscal year, and thus far, this projection appears quite credible. In the past, government economic forecasts have erred mostly on the side of conservatism. Real growth for calendar 1981 is now estimated to have been over 10%—more robust than last year's official projection of 8% and quite a remarkable performance in view of the world recession and rising protectionism.

Mexico offers business support program following peso devaluation.

The Mexican Government has initiated a number of measures to help the economy and business firms adjust to last month's peso float and devaluation. In order to reduce demand and inflation pressures, the authorities have cut public expenditures 3% and lowered import tariffs on 1,500 goods. In the way of more direct assistance for business, the government will allow firms federal income-tax deductions for up to 42% of any foreign exchange losses from the February devaluation, as well as deferral of income tax payments for up to one year, on a case-by-case basis. In addition, companies that import equipment can take advantage of a special swap program that absorbs exchange rate risk. The adjustment program also includes other measures directed toward helping firms meet increased liquidity needs resulting from higher costs associated with the devaluation. In general, the government hopes this program will encourage continued business investment through this difficult period for the Mexican economy. If the government itself supports these intentions with fiscal caution and control of public sector credit, the proper environment will be created for business investment decision-making.

Modest improvement in Kenyan economy expected, despite continued imbalances.

Despite marginal improvement in its performance in 1981, the Kenyan economy continues to experience substantial imbalances. Real GDP is reported to have registered 3%-4% growth in 1981, up from 2.4% the year before, and the current account of the balance of payments appears to have narrowed its deficit by some 15%, to an estimated $835 million. However, a growing budgetary gap has necessitated increased resort to inflationary central bank finance. Moreover, external sector reserves have fallen to a 5-year low, while liabilities have risen sharply. The mild deceleration of price increases earlier in the year was undoubtedly reversed toward year-end, following a 15% devaluation of the shilling in September. This year, favorable rains suggest some improvement in economic growth—possibly to 5%. But no narrowing of the budgetary deficit nor any decrease in the rate of inflation is expected. While some further decline in the current-account deficit is likely, the low level of external reserves will require shifting the financing of the shortfall entirely to foreign sources.

A Lasting Deceleration in Inflation?

Inflation is slowing more quickly than seemed likely just last summer, when prices were rising at double-digit rates. The producer price index actually fell 0.1% in March, bringing the year-over-year increase to 5.4%, down sharply from the 12.9% peak in 1980. The slowdown in consumer prices has not yet been quite so dramatic, but February's 0.2% increase still brought the year-over-year increase down to 7.7% from 13% in 1979.

As welcome as this deceleration in inflation is, however, the rate is still high by historical standards. Moreover, economists do not agree on whether this decline will continue beyond this year. Some argue that the decline is only temporary, a result of the recession in 1980 and the current downturn that began in mid-1981. In this view, the recovery expected later this year and in 1983 would likely bring a reacceleration of price rises. Other economists, however, contend that the current slowdown in inflation is a result of the Federal Reserve's more stringent monetary policy that started in 1979. And as long as money growth continues to moderate, so will inflation.

Those who argue that the decline in inflation is the result of cyclical forces—and thus temporary—generally use a "bottom-up" approach to analyzing inflation. That is, they look at the trends in the costs of various factors of production—labor, raw materials, and capital—for clues as to what will happen to final output prices. For example:

- Labor costs are rising less rapidly as the demand for labor falls. Wage rates rose at a 9%-10% clip throughout 1980 and early 1981, despite an increase in unemployment, apparently in response to past inflation. But the demand for labor remained weak as the recovery proved to be short-lived. This, combined with a slowing of price inflation, has helped to temper labor's demands for higher wages. By late 1981, the increase in the average wage rate had fallen to 7%. Contract renegotiations in the auto industry and elsewhere should work to slow wage gains even further.
- Raw materials prices have fallen in four of the last six months, bringing the year-over-year increases down to about 8½% from 19% during 1980. Raw materials producers were initially hesitant to cut their own production and prices immediately in the face of weak demand, hoping to maintain their revenue. However, as inventories have piled up, excess supply has exerted downward pressure on both prices and output.
- Profit margins after taxes have shrunk by about 20% over the last two years, reducing the average return on capital. With lower sales volume and operating rates, most industries are having a hard time passing along even more modest cost increases.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1980		BALANCE				
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use cre lions
Austria	Export-led recovery in latter 1982 expected to produce 2% real growth this year.	Nov.	−2%	76.5	+3.1%	Jan.	5,031	+ 2%	2.9	
Belgium	New government loosens wage indexation, tightens fiscal policy; little growth expected in 1982.	Nov.	−1%	118.7	+2.0%	Jan.	4,433	−43%	0.9	
Britain	Official forecast points to stepped-up growth in 1982, but recent statistics remain stubbornly flat.	Jan.	0	524.6	−1.4%	Jan.	14,913	−29%	1.7	
Denmark	Central bank has warned recovery could be weakened by huge budget deficit, now 10% of GDP.	Nov.	+3%	64.7	−0.2%	Jan.	2,306	−29%	1.6	
Finland	Economic growth continues but its pace is slowing.	Nov.	0	51.0	+ 6.0%	Jan.	1,275	−22%	1.1	
France	Business surveys continue to note optimism over near-term output prospects.	Jan.	+2%	657.0	+1.6%	Dec.	22,262	−19%	2.3	
Germany	Domestic activity remaining weak; leading indicators fail to show imminent upturn; unemployment rising.	Jan.	0	822.2	+1.8%	Jan.	41,612	−14%	3.1	
Ireland	Restrictive policies will prevent any economic growth this year.	Oct.	+2%	17.6	+1.9%	Jan.	2,513	− 6%	2.9	
Italy	Real GDP down an estimated 1% in 1981; sluggish recovery expected after mid 1982.	Jan.	−2%	394.9	+4.0%	Jan.	19,286	−13%	2.6	
Netherlands	Economic activity remains depressed; recovery hopes hinge on exports.	Dec.	−3%	159.9	+1.0%	Jan.	8,904	−21%	1.6	
Norway	Oil and gas output down for first time since production began; GDP unlikely to increase this year.	Dec.	+3%	55.4	+3.6%	Jan.	6,024	+13%	4.5	
Portugal	Inflation and tight government budget putting squeeze on real wages and consumer spending.	Oct.	0	23.5	+5.5%	Dec.	544	−32%	0.8	
Spain	Real growth in 1981 was 0.5%; somewhat stronger—but still modest—growth projected for 1982.	Oct.	−3%	195.9*	+1.5%	Dec.	10,805	− 9%	4.1	
Sweden	Economy remains depressed; unemployment figures have reached new record levels.	Nov.	−4%	122.9	+1.4%	Jan.	3,389	−13%	1.4	
Switzerland	Gloomy business prospects for 1982; GDP may decline some 1%.	Sept.	+4%	105.8	+3.9%	Jan.	10,988	−11%	4.4	
Turkey	Economic growth resumes; real GNP in 1981 officially estimated to have expanded over 4%.	n. a.	—	60.2	−0.7%	Dec.	1,285	+ 1%	1.8	1,
Canada	General business conditions at low level of activity with unemployment rising.	Dec.	−4%	274.0**	+3.0%	Feb.	2,695	+10%	0.6	
United States	Indicators point to end of economy's steep slide, but not yet to vigorous recovery.	Feb.	−7%	2,922.2**	+1.9%	Jan.	18,946	+10%	0.8	

*1979 **1981

By the same token, according to those who argue that the current slowdown in inflation is a cyclical phenomenon, as an economic recovery takes hold, the increase in demand for labor and raw materials will put upward pressure on their prices. And at higher levels of output, producers will be in a better position to pass along these cost increases and to rebuild margins, as well. Hence, it is asserted, inflation will speed up.

Although this viewpoint may have some validity in a purely descriptive sense, it has some serious analytical shortcomings. It essentially says that higher prices cause higher inflation—not a very enlightening statement.

An analytically sounder "top-down" approach to inflation forecasting is provided by economists who zero in on forces determining total spending in the economy. Many in this group see money growth as the primary determinant of inflation. Rather than focusing on relative movements of individual prices, which may simply reflect shifts in the supply-demand balance between markets, they look directly at forces that influence the general price level.

Changes in the quantity of money in circulation determine changes in the total value of transactions, or "nominal" demand (assuming that individuals' willingness to hold money remains unchanged), while total "real" demand in the long run is determined by the growth of factor inputs—labor, raw materials, and capital. So money growth in excess of the growth in real activity is likely to result in the bidding up of all prices—that is, in a rise in the general price level, or inflation.

If money growth slows as it has done, on average, for nearly three years, the growth of nominal demand also must slow. Were price-setting behavior to adjust immediately, the level of real economic activity would be unaffected: only inflation would be lower over the time period. However, any price rigidities or delays in renegotiating contracts will have depressing effects on real growth in the short run, because relative price shifts lead to distortions and imbalances in real demand. Once all the price adjustments are made, real economic growth can resume its long-run path based on the growth of factor inputs.

Every post-war recession has been preceded by a period of relative monetary stringency, so it is easy to see how analysts could confuse the patterns of causation of slowing inflation during recessions. More important, however, is the fact that money growth has accelerated during or just after every recession, leading to the all-too-familiar ratcheting upward of inflation.

If the pattern of decelerating inflation is to outlast the current recession, then, a reversion to the earlier pattern of rapid monetary expansion after a recession clearly must be avoided. The question foremost on policymakers' minds is how much of a recovery the economy can eke out, given the Federal Reserve's restraint on nominal demand as it seeks to lower inflation. The faster that price-expectation adjustments occur, the less real output will be lost. Thus, the rapid drop in inflation, and the highly publicized labor concessions, are good news for U.S. economic prospects.

Douglas L. Bendt

OF PAYMENTS		MONEY AND BANKING							COUNTRIES
of IMF dit, mil- of dollars	current influences on payments	12-month changes				central bank rate†	exchange rate in U.S. dollars Mar. 24, 1982	current monetary conditions	
		latest data	consumer prices	latest data	money supply(M1)				
0	Current-account deficit was 38.1 billion schillings in '81, vs. 46.8 billion in '80.	Dec.	+ 6%	Nov.	— 3%	6.75%	.0590	Interest rates ease in line with German rates.	**Austria**
0	Franc devalued by 8.5% against DM in attempt to cut growing trade gap.	Feb.	+ 8%	June	+ 7%	13.00%	.0223	Downward pressure on franc reverses interest-rate fall.	**Belgium**
287	Current-account surplus likely to remain high after 1981's $16-billion record.	Feb.	+11%	Dec.	+15%	12.83%	1.8035	Sterling weakness prevents substantial interest-rate fall.	**Britain**
0	Economy still suffering from substantial current-account deficit.	Dec.	+12%	Oct.	+13%	11.00%	.1229	Continued capital outflows point to rising interest rates.	**Denmark**
60	Jan. saw a fmk. 248 million trade surplus after Dec.'s fmk. 757 million deficit.	Dec.	+10%	Oct.	+12%	9.50%	.2175	Monetary policy remains reasonably restrictive.	**Finland**
0	Current-account deficit of FF40 billion in 1981 may double this year.	Feb.	+14%	Oct.	+16%	9.50%	.1612	Weaker franc in EMS limits interest-rate cuts.	**France**
0	Current-account deficit down to 17.7 bn. DM in '81; small surplus likely in '82.	Feb.	+ 6%	Nov.	— 2%	7.50%	.4188	Special Lombard rate reduced to 9.5%.	**Germany**
0	Trade deficit remains unacceptably large at 144 million pounds in Feb.	Nov.	+23%	Dec.	+ 3%	16.50%	1.4650	High interest rates needed to defend Irish pound.	**Ireland**
0	Current-account deficit in 1981, estimated at 9 trillion lira.	Feb.	+17%	Sept.	+10%	19.00%	.000765	Banks' interest rates ease slightly.	**Italy**
0	Trade balance in '81 showed 6.7 bn. guilder surplus, vs. 5.3 bn. deficit in '80.	Feb.	7%	Nov.	+ 1%	8.00%	.3805	Interest rates reduced as guilder remains near top of EMS.	**Netherlands**
0	Trade balance remains in surplus despite fall in oil export value.	Jan.	+12%	Sept.	+14%	9.00%	.1548	Rules restricting foreign purchases of stocks relaxed.	**Norway**
41	Soft oil prices should help reduce current-account deficit in 1982.	Nov.	+25%	Sept.	+19%	18.00%	.0150	Monetary growth remains high.	**Portugal**
163	Peseta has exhibited weakness in Feb. and March.	Dec.	+14%	Nov.	+11%	8.00%	.00950	Money supply (M3) growth was 1% under target in 1981.	**Spain**
0	Trade account swung into Kr. 600 million surplus in Feb.	Dec.	+ 9%	n. a.	—	11.00%	.1702	Central bank discount rate cut to 10% in mid March.	**Sweden**
0	Loss of export competitiveness may curtail further current-account strength.	Feb.	+ 5%	Nov.	— 6%	6.00%	.5268	Interest rates fall as central bank boosts liquidity.	**Switzerland**
293	Current-account deficit shrank to $2.1 billion in '81 from over $3 billion in '80.	Dec.	+30%	Dec.	+23%	30.25%	n. a.	Money remains tight.	**Turkey**
0	Imports down as economy slows.	Feb.	+12%	Feb.	— 4%	15.04%	.8168	Interest rates at high levels.	**Canada**
0	Outlook for current account improved with oil price break.	Jan.	+ 8%	Feb.	+ 7%	12.00%	—	Money growth declines, but remains above yearly target.	**United States**

†most recently reported

World Interest Rates

market rates of March 24, 1982; bond yields as of March 19, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	15.04	12.83 intervention rate	13.00	9.50	7.50	19.00 penalty rate 22.00	8.00	6.00	5.50
Day-to-Day Money	14.00 March 25	15.04	13.75	9.25	17.00	9.55	20.375	5.00	5.50	6.6875
Treasury Bills 91-day, Middle Rates	12.67 discount basis	14.90	12.5625	14.25	n. a.	n. a.	18.30 90-days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	13.50 finance paper discount basis	15.65 finance paper 15% tax w/h	12.185	12.90 Certified	16.875 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.60	15.60 15% tax w/h	12.5625	12.90 Certified	not traded	9.40	21.9	no market	5.875	no market
Government Bonds Long-term, new and old issues, average yield	13.66	15.50	13.33	10.715 20% tax w/h	16.15	9.32	20.18	10.26	5.30	7.20
Industrial Bonds prime, long-term, new and old issues, average yield	14.90 Aa Industrials	17.00	14.66	15.68	16.91	9.24	20.45	11.02	6.36	6.91
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	16.50	14.50	17.00	15.95	13.00	21.75 ⅛ qtrly fee on outstdng.	11.00	9.50	6.00
Bank Time Deposits 3-month	13.95 Cert. of Dep.	16.20	13.437	14.25	17.00	9.35	10.75	8.25 large deposits	5.50 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	14.8125	no market	13.5625	no market	27.00	9.125	no market	7.9375	5.8125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8172	1.8030	.0222	.161	.4193	.000767	.3785	.5273	.004108
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.269 *D*	1.35 *P*	2.218 *D*	12.951 *D*	5.80 *P*	12.533 *D*	7.265 *P*	9.302 *P*	8.424 *P*

Eurodollar Deposits
(London, interbank, bid)
March 25

7-day	14.375
1-month	14.8125
3-month	15.00
6-month	15.0625

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.07
U.S.-Canada Treasury Bills	− .231
U.S.-Canada Finance Co. Paper	− .666
Eurodollars-U.K. Local Auth. Deposits	+ .150

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.125
Over 7 yrs.	15.00
DM Bonds	
7 yrs. and under	9.375
Over 7 yrs.	9.625

Gold Price
London
afternoon fixing
331.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Saudi Arabia: Projected oil exports needed to meet government's annual financial requirement

(billion dollars, current prices, calendar years)

		1980 (Base)	Third Plan Period					
			1981	1982	1983	1984	1985	1986
	Total budget outlay	$60.0[1]	70.0	85.0	95.0	100.0	100.0	115.0
Less:	**Non-oil income**	$12.2	17.6	17.2	17.6	18.8	19.6	20.9
	Gas, Petrochemical, and other exports[2]	3.5	4.4	5.0	5.1	6.0	6.5	7.5
	Income from foreign assets[3]	7.5	11.7	10.4	10.4	10.4	10.4	10.4
	Other budget income[4]	1.2	1.5	1.8	2.1	2.4	2.7	3.0
Equals:	**Oil export income requirement**	$47.8	52.4	67.8	77.4	81.2	80.4	94.1
Thus:	**Implied oil export requirement**[5]							
	If net revenue per barrel (yearly average) is:		$31.25	32.30	32.30	32.30	32.30	32.30
	Then, needed export volume is (mbd):		4.6	5.8	6.6	6.9	6.8	8.0

[1] Based on *actual* budget outlays in fiscal 1979/80 and 1980/81 of $56.23 billion and $63.66 billion, respectively, representing 89.2% and 80% of budgeted (including supplementary) allocations. [2] Estimates by Chase Energy Economics. [3] Assumes 8% rate of return during 1982-86 on official foreign assets of $130 billion at end-1981 which are not drawn-down. [4] Mainly customs duties and pilgrims' receipts. [5] Assumes marker price holds at its current level of $34 through 1986.

Data: Chase Economics Group estimates

Saudi Arabia: How Much Room to Maneuver?

In a surprising demonstration of unity, members of the Organization of Petroleum Exporting Countries have successfully interjected an element of doubt into expectations that world oil prices would continue to plummet. At their recent meeting in Vienna, OPEC oil ministers agreed to cut production—effectively by some 700,000 barrels per day—in hopes of taking up the current slack in the world oil markets. Saudi Arabia took on the principal burden of the adjustment by deciding to reduce its daily production by 500,000 barrels beginning April 1. This would bring its Aramco output ceiling to 7 million barrels per day (mbd)—well below its "traditional" ceiling of 8.5 mbd and a huge drop from its overall production peak of 10.6 mbd during October of 1980.

Whether this large production cut by the Saudis, combined with output curbs by the other OPEC members, will be sufficient to prop up the cartel's pricing structure remains to be seen. If it is not, further reductions may be required, and Saudi Arabia will undoubtedly play the pivitol role in the OPEC pricing drama once again. Thus, one of the questions most critical to the oil price outlook is: How much further will the Saudis be willing and able to pare back production?

Until recently, Saudi Arabia had been producing petroleum at a rate far above 8.5 mbd and much more than necessary to meet its overall financial requirements. Including its share of yields from the Neutral Zone, Saudi oil output averaged 9.5-10 mbd from the 1978 fourth quarter through 1981. This stepped-up production helped fill the gap in world oil supplies resulting from the 1978-79 Iranian Revolution and the on-going war between Iran and Iraq that began in September 1980. Nevertheless, the yearly average contract price of OPEC oil soared to $34.40 in 1981 from $12.90 in 1978—an increase of 167% in just three years. Without the higher Saudi Arabian production, oil prices undoubtedly would have risen even more rapidly, as stock-building demand for oil during much of this period was exceptionally strong, owing to fears of further supply disruptions. Moreover, this high level of output has been one of the principal causes of the downward pressure on world oil prices that intensified greatly in the early part of this year.

Saudi production policy

Despite the positive price effects for the oil-consuming nations, Saudia Arabia's production policy reflects not altruism, but rather an enlightened self interest that stems from three main concerns. First and foremost, the kingdom has proven oil reserves in excess of 168 billion barrels—25% of the non-communist world total. These have a life expectancy of several decades, and the country will remain heavily dependent on them to finance economic development. Saudi officials are quite clearly concerned that too rapid an increase in the relative price of oil would elicit such marked gains in oil-use efficiency and expanded use of alternative sources of energy that the kingdom's long-term oil market would be endangered. Second, to the extent that overly rapid increases in the price of oil contribute to higher inflation in industrialized nations, the Saudi economy is adversely affected: Import costs increase, giving rise to higher domestic inflation, and the real value of Saudi Arabia's large stock of foreign investments erodes. At the end of the last year, the country's foreign assets totaled an estimated $160 billion, of which about $130 billion were officially held. Third, the Saudis recognize their political as well as economic interdependence with the rest of the world. If too rapid an increase in the relative price of oil contributes to economic dislocation, then adverse political changes in friendly countries could result, and Saudi Arabia's strategic interests would be jeopardized.

How big a cut?

It now appears that Saudi Arabia seriously underestimated the extent to which world demand for OPEC oil would drop this year. Unexpectedly strong conservation in the use of oil, switching to alternative sources of energy, continued expansion of non-OPEC petroleum supplies, and persistent recession in the industrialized nations have severely weakened the demand for OPEC oil. And in the face of unusually high interest rates, consumers have heavily drawn down oil inventories in recent months. Whether OPEC's just agreed upon production cutbacks will be sufficient to absorb the current glut of oil depends on when—and if—demand firms. This may be later in the year, depending on both how much longer the inventory drawdown continues and when the economic recession in the West bottoms out. The OPEC ministers are monitoring trends closely and have indicated their readiness to take further action. Should it become necessary to impose additional output cuts, it is clear that Saudi Arabia would have to bear the brunt of the adjustment, given that production by the other OPEC nations is already extremely constrained.

Hence the critical question that arises is: To what extent could Saudi Arabia cut its oil exports and still meet its financial requirements without incurring budget deficits or reducing the level of its officially held foreign assets? The answer to that question depends

Saudi Arabia: How Much Room to Maneuver?

(continued from page 7)

on several key variables: a) the government's projected spending levels, b) future non-oil income, c) associated gas needs, and quite obviously, d) the price of oil.

Unofficial estimates of future levels of government expenditures have differed widely. Despite shortfalls in the implementation of development projects during Saudi Arabia's second five-year plan period, which covered fiscal years 1975/76-1979/80, state budget civilian *and* military outlays totalled $198 billion in current prices. This equalled 84% of projected spending in inflation-adjusted terms. Under the third development plan (fiscal years 1980/81-1984/85) which is currently being implemented, civilian expenditures alone as originally proposed totalled $234 billion in constant (1979/80) prices. This spending target reportedly has since been raised by 15%. The plan also includes an allowance for inflation of 7% in the case of new projects, although domestic inflation, as measured by the non-oil GDP deflator, is more likely to average around 10% over this five-year period. When outlays on defense and internal security are added, plus internal transfer payments and foreign aid in the form of grants and loans, *overall* spending by the government during 1981-85 will be close to $450 billion in current prices.

The table on page 6 illustrates the annual pattern these expenditures could follow over this five-year period and the concomitant implications for Saudi oil revenue needs. Included in these calculations are: projected state income from the export of natural gas liquids and from petrochemical and other industrial projects currently under construction, estimated returns on foreign assets, and other budget income. It is conservatively assumed that the petrochemical and other industrial projects, due on stream during 1983-85, do not attain full capacity production before 1987. Associated gas needed for fuel and feedstock for Saudi industries and power stations by that date requires crude oil exports of at most 6 mbd, given that a large portion of the gas currently produced is still unutilized, that Saudi fields have high gas-to-oil ratios, and that dual-fuel systems are readily available.

Saudi Arabia's minimum oil export needs

(million barrels/day)

If price of marker crude*:	Oil exports 1982	1983	1984	1985	1986	Annual average 1982-85
A. Holds steady	5.8	6.6	6.9	6.8	8.0	6.5
B. Rises moderately	5.8	6.6	6.4	5.8	6.2	6.2
C. Collapses	6.5	8.8	9.2	9.5	11.1	8.5

*Refers to current dollar price of Saudi Light oil, now $34 per barrel. In scenario A, marker holds to 1986; in B, it rises 8% in 1984 and 1985, 10% in 1986; and in C, it falls to $28 in April 1982, $25 in 1983 and 1984, and to $24 in 1985 and 1986. Calculations are based on the estimated oil income requirement (see table on page 6) and weighted average net government revenue per barrel. They do not account for output needed to meet domestic oil consumption.

Data: Chase Economics Group estimates

The table on page 6 shows projected requirements for Saudi Arabia's oil export income under these assumptions from 1981 to 1986. In the table below, these are then translated into the associated minimum oil export volumes that would meet these requirements under various oil-price assumptions. If the current benchmark price holds at $34 per barrel thru 1985, the kingdom could cut its exports to an average of 5.8 mbd this year (that is, cut production to 6.3 mbd including oil for domestic use) and export an average of 6.5 mbd during 1982-85. If the marker holds through 1983, then rises 8% in 1984 and 1985, Saudi exports would average 6.2 mbd during this period. But if the marker collapses—for example, falling to $28 by April and to $24 in current dollars by 1985—then, to meet its annual budget requirement, Saudi Arabia would need to sharply and steadily increase oil exports from 6.5 mbd this year to 9.5 mbd by 1985, and possibly to 11 mbd by 1986.

Implications

Several important conclusions can be drawn from this analysis. First, if demand for OPEC oil does *not* decline steadily in the 1980s, Saudi Arabia could contribute significantly to defending the benchmark oil price and still meet its overall budgetary needs by cutting exports to as low as 5.8 mbd this year—that is, about 1 mbd *less* than the level implied by the new Aramco output ceiling for April—and by selling an annual average of no more than 6.2-6.5 mbd thru 1985.

Second, and apart from the pressing needs of other OPEC members, it is in the Saudi's interest to defend the current benchmark price. If they do not, or cannot, and if the OPEC price structure collapses as a result, the Saudis would be faced with two choices: They either would be forced to sharply cut their own spending targets, as even a total drawdown of foreign assets would finance only two years of expenditure at currently projected levels; or they would have to expand future oil exports very sharply. Given the slow growth in world demand currently projected for OPEC oil, this latter alternative would seriously conflict with the oil export requirements of other OPEC members. Thus, continued downward pressure would be exerted on nominal oil prices through at least the mid-1980s. Steadily expanding production could, moreover, heighten the reported conflict within Saudi Arabia between those who have favored and those who have opposed high oil output, whereas lower production would alleviate potential tensions.

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OPEC's Surplus Vanishes

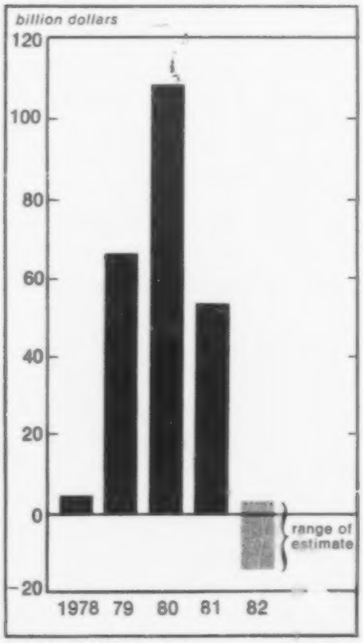
Once again a massive OPEC surplus has disappeared. This time around, it shrank even more quickly than after the 1973-74 price shock. In 1980, the combined current-account position of the OPEC membership showed a surplus of nearly $110 billion. Over the first half of this year OPEC will incur a significant current-account deficit. For 1982 as a whole, the best OPEC can expect is a current account that is close to balance, and an aggregate deficit of $15 billion or so is clearly possible.

The decline in the OPEC surplus last year reflected both a rapid growth of imports and a decline in oil revenues. The shift this year is primarily the result of reduced oil revenues, particularly lower export volumes. OPEC oil exports (excluding natural gas liquids) in 1981 averaged 19.6 million barrels per day (mbd). This year the volume of oil exports is projected to fall in the 16-17 mbd range, implying total OPEC production of 19-20 mbd. The higher estimate presumes about a 2% fall in free-world oil consumption compared with last year and an average stock drawdown of 1.2 mbd. For this estimate to be realized, however, there must be a significant recovery in the level of economic activity in the OECD countries over the second half of the year.

While there has been much speculation as to the possibility of a sharp fall in oil prices from current levels, the suspicion here is that the current structure of OPEC contract prices will hold through year-end. However, significant discounting in various forms, such as spot sales and bilateral arrangements, over the next quarter or two will result in an average effective price of roughly $32.50—less than the projected average contract price for 1982 as a whole of $33.20.

The $110-120 billion swing in OPEC savings over the past two years is a shift of enormous magnitude—close to 1% of the combined GNP of the non-centrally-planned economies. This has been offset in part by savings increases in oil-importing countries, but *ex ante* global savings have clearly been reduced. This shift has probably had little if anything to do with the very high level of real interest rates of the past year. Looking forward, however, the reduction in global savings implied by the disappearance of the OPEC surplus could prove to be a significant offset to the downward push on real borrowing costs implied by the prospect of a resolution of the conflict in the U.S. between inflation expectations and Federal Reserve money-growth targets. In short, real interest rates could stay higher for longer than had been expected.

OPEC current-account balances*



*Including official transfers

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Swiss monetary policy eased, prompting fall in interest rates.

Switzerland's continued economic slowdown, coupled with expectations that inflation pressures will subside somewhat this year, has led the Swiss National Bank (SNB) to ease its monetary policy. As signs of the economy's growth tailing off have become apparent over the past few months, a consensus has emerged among economic forecasters that real GDP will fall by some 1% this year. This and recent movements in the Swiss franc exchange rate have helped to calm central bank fears about inflation, which last year averaged 6.5% at an annual rate. Over the past six months, the Swiss franc has appreciated 10% in real, trade-weighted terms. At the same time, however, the SNB has been particularly concerned about the franc's strength relative to the German mark. Substantial liquidity has now been injected into the banking system. And as a result, Swiss short-term interest rates have fallen by some 4% since the beginning of the year. As monetary growth picks up, the Swiss franc may weaken appreciably in terms of the mark, bringing a halt to the decline in interest rates.

Dutch current account in surplus last year owing to striking advance in trade balance.

Holland registered a sharp turnaround in the current account of its balance of payments in 1981. According to provisional figures, the current account showed a surplus of 8.65 billion guilders last year compared with a deficit of 4.48 billion in 1980. Much of the reversal was attributable to a 12.7-billion-guilder improvement in the Dutch trade balance, which by far offset a 400-million-guilder decline in invisibles. A sharp domestic recession which reduced import demand and higher prices for Dutch natural gas exports contributed to the dramatic improvement in the trade balance, but perhaps even more important was the emergence of a competitive advantage for Dutch exports. International competitiveness advanced markedly as the effective (trade-weighted) exchange rate of the guilder depreciated by almost 7%, while Dutch labor costs rose by much less than those of the country's trading partners. This year, the current account is expected to show another substantial surplus, although it is not likely to be as large as in 1981.

Export surge boosts Turkey's trade balance.

Turkish exports rose by some 62% in 1981, helping to narrow the country's current-account deficit to $2.07 billion from $3.29 billion in 1980. A substantial devaluation of the Turkish lira, weak domestic demand, and liberalized foreign-trade regulations induced producers to switch from domestic to foreign markets. Moreover, the Iran-Iraq war increased demand for Turkish goods significantly, as exports could be brought into these countries via land routes. In addition, interest-rate subsidies to exporters allowed companies to obtain cheap credit by exporting. While exports are expected to show another healthy rise this year, a key question for the trade-balance outlook rests on whether Turkey's industrial structure is becoming less import-intensive. If so, then a recovery in production owing to stronger export demand would not necessarily be followed by a sharp rise in imports.

Jamaica: positive developments among continuing problems.

After nine consecutive years of decline, the Jamaican economy at long last registered positive real growth in 1981. Based on strength in the construction and agricultural sectors, real GDP rose 1.2%—a modest turnaround from the 23% cumulative decline since 1972, but nevertheless noteworthy. Other encouraging economic developments included a dramatic drop in the rate of inflation—to 6% in December from 29% a year earlier—and a two-percentage-point fall in the unemployment rate down to 26%. The inflation progress reflected a big improvement in the availability of goods, as well as softer world oil prices, and tighter demand-management policies. In the external area, however, Jamaica posted a threefold widening of the current-account deficit to $463 million, as exports fell far short of expectations. Bauxite and alumina sales stagnated because of sluggish world demand, while production of sugar and bananas continued the declining trend of the past decade. Imports, on the other hand, increased sharply—up 18%—reflecting liberalization policies and pent-up consumer demand. Tourism activity, in spite of some expansion, remained sluggish owing to the depressed level of economic activity in the industrial countries.

Brazil adopts money and credit targets as anti-inflation strategy.

Brazilian monetary authorities are restricting the growth of money and credit in a continuing effort to bring down the country's high rate of inflation. The inflation rate has declined this year, but the reduction has been small: from an annual rate of 95% in December to almost 92% in March. Consequently, the National Monetary Council has set restrictions aimed at keeping the growth of commercial bank credit for this year's second quarter to 9%, following a 5% expansion in the first quarter. For all of 1982, the credit growth target is 50% for large commercial banks—down from last year when bank credit jumped by 110%. As a result of strong loan demand and the restraint program, domestic lending rates are currently at around 140%-150% per annum. Although high in real terms, these rates also act to stimulate the inflow of lower-cost foreign loans needed to help finance Brazil's balance-of-payments deficit. If the government's credit targets are met this year, progress could be made in both reducing inflation and meeting foreign finance needs.

India's domestic production revives, sharply slowing import growth.

The Indian economy recorded real growth of about 4.5% in fiscal 1981-82 just ended, after a sharp 7.5% rebound in growth in 1980-81. Agricultural output increased 3% or more, while industrial production surged over 8% as infrastructural bottlenecks eased. Average wholesale price inflation moderated to about 10% from 18% in 1980-81. Because of the recovery in domestic production, particularly of petroleum, import growth slowed sharply. As a result, with somewhat better export growth, the trade deficit, at around $6.8 billion, was about the same as in 1980-81. The current-account deficit, however, is likely to have risen to over $4 billion from $3.2 billion the previous year. In 1982-83, real growth is again likely to be about 4%-4.5%, and wholesale price inflation is expected to remain in the 8%-10% range. The trade and current-account deficits are likely to widen further as a big increase in investment and further liberalization measures spur imports.

New Zealand economy strongly influenced by government policies.

Government stabilization efforts have revived the New Zealand economy from last year's recession. Real economic growth for the just-ended fiscal 1981-82 is estimated to have been over 2%, compared with fiscal 1980-81 which registered an 0.8% decline according to preliminary government figures. The government largely precipitated the slump when it tightened monetary and fiscal policies in early 1980 in an attempt to minimize the domestic impact of the second oil price shock. After that strategy resulted in recession and continued inflation, the government shifted to an expansionist stance: Money supply (M1) growth accelerated to 13.7% in fiscal 1981-82 after growth of only 2% in the previous year; and the budget deficit went up by 50%. As a result, and because the oil shock had run its course, real growth did pick up. For the year ahead, slower growth is expected—probably about 1% or slightly higher—as the government may revert back to deflationary policies out of concern for inflation and an increasing current-account deficit.

Iraqi development program as yet little affected by sharp oil export decline.

Although the war between Iran and Iraq has had a major impact on Iraqi oil exports, it has yet to have a serious effect on Iraq's ambitious development program. With the closure of gulf oil export facilities, Iraqi oil production in 1981 averaged only 900,000 barrels per day, compared with 3.5 million barrels daily prior to the outbreak of war. As a result, oil export revenues fell by 65% to $9.5 billion. However, government spending continued unabated, and a record $23 billion in contracts was approved during the year. Imports, excluding military goods and services, grew by 24% resulting in a current-account deficit of $8.2 billion. Given Iraq's generous supply of foreign exchange reserves—$30 billion in late 1980—and interest-free loans from her gulf Arab allies, financing the deficit presented little problem. It is only in recent months, with no signs of an early recovery in oil exports, that there have been increasing pronouncements that imports in 1982 may be held at last year's levels or even possibly reduced.

Monetary Policy and Business Failures

The severity of the 1981-82 downturn, coming as it has after nearly three years of stagnation, has heightened fears about the mounting number of bankruptcies. The Dun and Bradstreet business failure rate in recent months has set a post-World War II record of more than 70 bankruptcies per 10,000 operating businesses. The unusually high rate has generally been attributed to the recession. Closer analysis from a somewhat different perspective, however, reveals that the greater number of bankruptcies may also be a by-product of the Federal Reserve's 1979 shift in operating strategy and its continued determination to bring down the rate of inflation.

Microeconomic theory teaches that if the price of one productive factor rises because of a supply shortfall, businesses will attempt to conserve on its usage. Because inputs are not perfectly substitutable in the short run, a major increase in the relative price of one input will usually be associated with a loss of output. Money and credit—just like labor, capital, and energy—can be thought of as factors of production in that they are used to cover payrolls and suppliers' bills. The reduced growth of the money stock and higher interest rates of the past two-and-a-half-years have had the same sort of impact on individual firms' production decisions as did the 1973-74 oil embargo and energy price hike.

The spurt in the real cost of credit has been closely associated with what can be considered a real money supply shortfall. From mid-1976 through 1978, "real" money growth—adjusted for inflation—was positive. Since 1979, however, it has been negative—sharply so over the last two years. Meanwhile, there has been an increase of 5 percentage points in the spread between the federal funds rate and the inflation rate.

Businesses will eventually adjust their operations to reflect the restricted availability of money and the higher cost of credit. But in the current transition period, two forces have worsened the impact. First, despite efforts to conserve on the use of credit, business financing pressure has increased as the rise in real interest rates has led to (1) a decline in the ratio of liquid assets to current liabilities and (2) an increase in the ratio of interest expense to cash flow. This has made total business costs more sensitive to fluctuations in interest rates. Second, the weak economy has decreased profitability, reducing firms' ability to withstand interest-rate or other cost shocks.

Thus, business failures may continue to rise over the near term. Nevertheless, stringent monetary policy has been accomplishing its primary task of slowing inflation. This has helped to bring down the cost of raw materials and other productive inputs, providing some relief to businesses and laying the foundation for a decline in the business failure rate.

Asia and Oceania

Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF PA				
			6 months ending	12-month change	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IM credit, mi lions of doll
Asia	**Bangladesh**	Military coup creates uncertainty about country's economic management.	Sept.	−13%	12.0*	$ 132	Feb.	215	− 32%	1.0	376
	Burma	New four-year plan, beginning April, targets real growth of 6.2%.	Jan.	− 3%	5.6*	174	Feb.	197	− 32%	7.4	55
	China, People's Republic	Strong recovery taking place in heavy industry.	Dec.	+16%	242.2	246	Dec.	5,048	+ 98%	3.0	508
	Hong Kong	Government budget for fiscal 1982-83 contains general tax cut and slower spending growth.	Oct.	+24%	21.5	4,290	n. a.	—	—	—	—
	India	New tax incentives proposed to spur domestic production and savings.	Nov.	−16%	159.3*	240	Nov.	5,066	− 30%	4.9	977
	Indonesia	Two foreign firms signed contract with Pertamina to build chemical complex.	Aug.	− 5%	66.3	437	Feb.	5,354	− 3%	5.1	0
	Japan	Public-works spending, housing loans accelerated to spur domestic demand.	Jan.	+ 8%	1,040.0	8,906	Feb.	27,939	+ 7%	2.4	0
	Korea	Further domestic stimulus and increased export credit likely.	Jan.	+13%	56.6	1,482	Feb.	2,821	+ 2%	1.3	1,321
	Malaysia	Prolonged drought could cut rice production by around 30%.	Oct.	−19%	22.7	1,690	Dec.	4,098	− 7%	4.3	214
	Pakistan	Poor export perfomance depresses domestic production.	Dec.	− 9%	30.6*	366	Feb.	707	+ 10%	1.6	731
	Philippines	Economy remains depressed because of poor commodity prices.	Oct.	− 5%	39.7**	801	Feb.	1,987	− 21%	2.7	925
	Singapore	Domestic demand high for construction, shipbuilding, oil rigs, and services.	Dec.	+ 6%	10.5	4,390	Nov.	7,478	+ 15%	3.2	0
	Sri Lanka	Spotty rains hurt rice crop; power situation improved.	Oct.	− 6%	4.1	277	Jan.	380	+ 46%	2.4	392
	Taiwan	Domestic investment picks up slightly, responding to government measures.	July	+15%	40.2	2,278	Aug.	4,468	+161%	2.3	0
	Thailand	Personal income taxes lowered, property tax imposed.	Dec.	+10%	36.0**	760	Feb.	1,402	− 3%	1.8	684
Oceania	**Australia**	Resources boom slows due to world demand uncertainties; unemployment rises to 7%.	Jan.	− 4%	137.4	9,401	Feb.	1,266	− 37%	0.6	0
	New Zealand	Mobil signed $750 million gas conversion project.	Jan.	+ 2%	22.5*	7,250	Feb.	347	− 15%	0.7	31
	Papua New Guinea	Immigration of Asian workers increases.	June	−16%	2.6	838	Feb.	399	+ 8%	n. a.	51

*Fiscal year **1981

Equity Issues Could Rise in 1982

One of the particularly troublesome aspects of the pattern of corporate financing that has emerged in the last few years is the relative dearth of new equity issues. In 1979 and 1981, for instance, the outstanding level of common stock actually declined, as stock repurchases outpaced new issues and stock swaps were executed in conjunction with takeover activities. As a result, corporate balance sheets now reflect a much greater reliance on debt financing—especially short-term instruments—than they did five years ago, exposing firms to a much greater degree of financial risk.

To a large extent, this trend reflects the poor performance of the stock market, since the cost of issuing new equity rises as a firm's stock price declines. The lackluster stock prices can be traced to several economic sources: First, corporate cash flow has been weak, owing to the prolonged slowdown in economic growth that has characterized the post-1978 period. In addition, real interest rates have remained unusually high since the latter part of 1979 when the Federal Reserve shifted to an aggregates management strategy. Finally, the economic and financial environment of recent years has been marked by substantially increased volatility that has caused investors to demand high risk premiums.

By historical standards, however, a stock market recovery is overdue. The Standard & Poor's Composite Index of 500 Common Stocks has fallen steadily over the past 16 months, compared with an average period of decline of 12 months during the other postwar bear markets. To be sure, historical comparisons can be misleading. However, a re-examination of the economic forces that help to determine stock values suggests that, on balance, a recovery in the second half of the year is quite possible.

First of all, the level of corporate cash flow that investors look for can be expected to rise in 1982. Sales should increase as lower inflation and the July tax cut leave consumers with more disposable income. At the same time, unit operating costs should fall as productivity begins to rise. In addition, because the increased depreciation allowances effectively lower the corporate tax liability, cash flow should rise.

Second, as long as the level of real interest rates remains high, it will be a negative influence on stock prices. However, to the extent that rates are determined by inflation expectations, a reasonable argument can be made that they will start to come down as inflation continues to decelerate.

Third, risk is manifested in investor perceptions of future earnings volatility. These originate from uncertainty about the economic environment and policy, which should be reduced as the economic recovery gets underway. Moreover, to the extent that default risk is relevant, this should also decline, as corporate bankruptcies become less frequent.

YMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				exchange rate in U.S. dollars	change from year earlier		
F il- lars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	April 7, 1982		current monetary conditions	
	Import restrictions remain.	Dec.	+14%	Nov.	+15%	.0520	−20%	Credit remains restrictive.	**Bangladesh**
	Agricultural exports to get boost under new plan.	Jan.	+ 2%	Apr.'81	+13%	.1345	−10%	Bank borrowing to finance 4.46-billion-kyat budget deficit.	**Burma**
	Foreign trade ministry reorganized.	Dec.	+ 3%	Dec.	+19%	.5395	−13%	Money supply surged at the end of 1981.	**China, People's Republic**
	Hong Kong and U.S. reach textile accord.	Oct.	+17%	Oct.	− 8%	.1716	− 9%	Foreign-currency deposits exempted from interest tax.	**Hong Kong**
	Tax incentives adopted to stimulate exports; import duty raised 5%.	Dec.	+13%	Sept.	+16%	.1190	− 2%	Credit conditions remain restrictive.	**India**
	Government seeks to replace log exports with plywood; oil production declines.	Dec.	+ 7%	Oct.	+29%	.00159	− 1%	Domestic fuel price increases heat up inflation.	**Indonesia**
	Capital outflows restrained in attempt to prevent further yen depreciation.	Feb.	+ 3%	Jan.	+11%	.004075	−13%	Long-term interest rates reduced 20 basis points.	**Japan**
	Liberalization of foreign direct investment being implemented slowly.	Jan.	+11%	Dec.	+ 5%	.00142	− 6%	Ceiling for won swap for foreign banks increased.	**Korea**
	Trade deficit of $319 million recorded in 1981.	Dec.	+ 9%	Dec.	+13%	.4272	− 2%	Current-account deficit will force higher external borrowing.	**Malaysia**
	Current-account deficit for fiscal 1981-82 could top $1.4 billion.	Dec.	+13%	Dec.	+ 9%	.1020	0	Rupee continues to depreciate against dollar.	**Pakistan**
	Steps taken to encourage invisibles earnings.	Jan.	+18%	Dec.	+ 4%	.1218	− 9%	New rediscount window opened for distressed industrial firms.	**Philippines**
	Trade deficit widens, capital inflows remain high, S$ depreciates slightly.	Jan.	+11%	Nov.	+13%	.4685	− 2%	Interest rates raised after recent declines.	**Singapore**
	Export prospects are dim, except for coconuts, owing to export duty change.	Dec.	+18%	Dec.	+ 7%	.0505	−12%	Rupee being held steady against dollar.	**Sri Lanka**
	Government bans some imports from Japan to redress bilateral trade gap.	Sept.	+15%	Sept.	+10%	.0280	− 3%	Money market eases; interest rates lowered.	**Taiwan**
	Import duties restructured; special import surcharge imposed.	Dec.	+12%	Oct.	+ 1%	.0460	− 9%	Withholding tax on deposit interest raised.	**Thailand**
	Capital inflows pick up slightly in recent months.	June	+ 9%	Dec.	+ 5%	1.0498	− 9%	Money supply growth on target; larger budget deficit likely.	**Australia**
	Manufacturing and wool exports slow; export subsidy cut for forest products.	June	+15%	Dec.	+14%	.7645	−16%	Share prices trending down.	**New Zealand**
	Various sources contribute $850 million for Ok Tedi project.	June	+ 9%	Oct.	−12%	1.4300	− 6%	Commercial borrowing will rise to fund current-account gap.	**Papua New Guinea**

World Interest Rates

market rates as of April 7, 1982; bond yields as of April 2, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.375	15.40	13.00 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.00	5.50*	5.50
Day-to-Day Money	14.25 April 8	15.00	12.875	12.00	17.00	9.50	20.50	9.00	3.938*	7.3125
Treasury Bills 91-day, Middle Rates	13.18 discount basis	15.15	12.9375	14.65	n. a.	n. a.	20.875 90-days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	14.00 finance paper discount basis	16.05 finance paper 15% tax w/h	12.28	12.90 Certified	16.75 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.10	15.90 15% tax w/h	13.00	12.90 Certified	not traded	9.40	21.70	no market	5.875*	no market
Government Bonds Long-term, new and old issues, average yield	13.81	15.75	13.15	10.968 20% tax w/h	16.065	9.11	19.72	10.32	5.13†	7.30
Industrial Bonds prime, long-term, new and old issues, average yield	15.15 Aa Industrials	17.00	14.51	16.123	17.05	9.07	20.49	11.05	6.21†	6.65
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	17.00	14.00	17.00	18.50	13.00	21.75 ⅛ qtrly fee on outstdng.	11.00	9.50*	6.00
Bank Time Deposits 3-month	14.125 Cert. of Dep.	15.90	13.8125	14.65	16.75	9.20	10.75	8.375 large deposits	5.00* residents only	3.75 20% tax w/h
Eurocurrencies 3-month asked	15.50	no market	13.75	no market	23.75	9.125	no market	8.3125	5.0625	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8122	1.7630	.0220	.1592	.4145	.000754	.3745	.5089	.00407
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	.787 *D*	1.636 *P*	2.455 *D*	7.523 *D*	5.269 *P*	10.066 *D*	7.159 *P*	10.260 *P*	8.740 *P*

Eurodollar Deposits

(London, interbank, bid)
April 8

7-day	15.125
1-month	15.50
3-month	15.5625
6-month	15.625

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.216
U.S.-Canada Treasury Bills	− .433
U.S.-Canada Finance Co. Paper	−1.043
Eurodollars-U.K. Local Auth. Deposits	− .1045*

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.25
Over 7 yrs.	n.a.
DM Bonds	
7 yrs. and under	9.75
Over 7 yrs.	9.75

Gold Price

London afternoon fixing

354.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
*Market rates as of April 7, 1982. †Bond yields as of April 2, 1982.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Feb.) 7.7	(Feb.) 11.6	(Feb.) 11.0	(Feb.) 13.9	(March) 5.2	(March) 16.1	(March) 4.7	(Feb.) 3.1
Industrial production*	(Feb.) −6.6	(Jan.) −4.9	(Jan.) −0.3	(Jan.) 1.6	(Jan.) 0	(Jan.) −1.7	n. a.	(Feb.) 3.3
Trade balance† *(billions of local currency units)*	(Feb.) −$1.2	(Jan.) C$1.29	(Jan.) −£0.13	(Feb.) −FF5.86	(Feb.) DM3.62	(Jan.) −Lit.1,540	(Feb.) −SF0.37	(Feb.) ¥308.1
Money supply (M1)*	(Feb.) +6.6	(Jan.) −2.2	(Jan.) 18.1	(Nov.) 14.8	(Jan.) −1.1	(Nov.) 7.7	(Dec.) −7.4	(Dec.) 9.7
Velocity of money (M1)*	(Dec.) 5.5	(Sept.) 15.7	(March'81) 4.5	(June) −0.2**	(Dec.) 6.6	(Sept.) 4.0**	n. a.	(Sept.) −1.1
Reserves minus gold *($ million, change from previous month)*	(Feb.) −30	(Feb.) −779	(Feb.) −155	(Feb.) 166	(Feb.) −513	(Feb.) −1,306	(Feb.) −54	(Feb.) −114

* Percent change from 12 months earlier. **based on GDP † Figures are only for the month indicated.

Wider LDC Loan Spreads Ahead?

Market sentiment appears to be growing that spreads on loans to developing countries are headed upward. Thus far, the only hard evidence of widening margins comes from the terms negotiated for recent syndicated credits to a few Latin American countries. Mexico, Argentina, and Chile have recently secured less advantageous terms than heretofore, and the high Brazilian spreads are apparently holding fast in spite of Brazil's improved balance-of-payments position. On the other hand, spreads on lending to Asian countries seem to be stickier, with terms on recent Korean and Malaysian borrowing still favorable to the borrower. Only in the case of the Philippines is there much evidence from the Asian market that higher spreads may be in the offing.

There are, however, other signs that the "borrowers' market" of the past three years is changing its tone: Maturities are shortening; the number of banks needed to be contacted in order to complete a syndication has increased; there is much more frequent resort to prime-based lending—markedly more attractive to U.S. lenders given the current differential with LIBOR-based loans; and, although the numbers are sometimes hard to pin down, front-end fees seem to be on the rise.

Bank perceptions of lending risk to the majority of the less developed countries (LDCs)—particularly those who are oil importers—have increased substantially over the past several years. Given this, the most interesting question now is not why spreads appear to be on their way up, but rather, why has it taken the market so long to demand greater rewards for greater perceived risk? In other words, why, over a period of ballooning current-account deficits and deteriorating debt-service and net foreign interest/export ratios, should the developing countries have been able to borrow on such generally favorable terms?

Although the average maturity of publicized Eurocredits fell in 1980, maturities were fairly steady through most of last year. And loan spreads have been reasonably stable on average since 1979, when they bottomed out after their slide from the 1975-76 peak. Indeed, until recently, the only evidence that the market perceived increased risks on LDC loans was the gradually widening differential between spreads on those loans versus loans to OECD members. That differential has been growing since early 1979.

The usual explanation of low lending spreads in terms of excess bank liquidity is hardly satisfying. In the first place, it is a misconception to think of international banks as being awash with funds. The great bulk of syndicated international lending is accomplished with funds borrowed competitively, and banks do not bid for funds without having previously identified attractive lending opportunities. In the second place, the most striking feature of the international financial market over the past several years has been the extremely high level of real (inflation-adjusted) interest rates. Last year the six-month LIBOR averaged 16.7%, while on a fourth-quarter-to-fourth-quarter basis U.S. inflation, as measured by the implicit GNP deflator, was only 8.8%. Such unprecedentedly high real rates of interest are hardly characteristic of an "excessively liquid" market.

What has been interpreted as a phenomenon related to excess liquidity would thus appear to be something rather different. The suspicion here is that the stickiness of spreads on loans to developing countries in recent years is the joint result of two forces: an increasingly competitive market and the availability to many international banks of funds at well below market rates.

Determining the spread

The price over LIBOR of a syndicated credit is determined by the minimum acceptable return over cost of funds to the marginal bank in the syndication—that is, the bank least willing to participate. In recent years the number of banks actively participating in international lending has grown significantly. This reflects not only smaller banks' increased access to information regarding lending opportunities in the international market, but also, in some countries, the relatively slow growth of credit demand in domestic markets.

The number of banks wanting to play a managerial role in international loan syndication has increased even more rapidly as banks have sought to protect overall rates of return in the face of lower spreads by securing a higher share of front-end income. Particularly noteworthy has been the assumption of an increased leadership role by heavily capitalized Arab banks who have high asset-growth targets and a strong desire for portfolio diversification. The predictable result of these developments has been increased downward pressure on lending spreads that has offset the perceptions of increased risk on the part of banks historically more active in international lending.

The effect on negotiated loan spreads of relatively large supplies of funds to banks at below-market rates is less clear cut. Historically, the tiering of deposit rates—that is, the emergence of significant differences between the deposit rates of most-favored and least-favored banks—has been associated with increased loan spreads. For example, although the rapid increase in spreads on loans to developing countries in 1975-76 was related in part to increased concerns about debt-service capability, it was also related to the marked tiering of deposit rates that followed the failure of Herstatt Bank. Indeed, a borrower in that period was sometimes given a choice between a base rate (LIBOR) defined in terms of the offer rates of the premium banks (together with a correspondingly high spread), and a base rate defined in terms of the offer rates of less favored banks (together with a correspondingly lower spread).

The deposit tiering of the past several years, however, has taken a different form. It has manifested itself not so much in terms of an increased dispersion of explicit market offer rates, but rather in the availability of funds to many banks at rates well below observed rates. This tiering of average deposit rates had its origins in the extremely rapid growth of OPEC deposits after the oil price rises of 1979-80 and in the preference by Middle Eastern countries for deposits in non-U.S. banks that followed the freeze of Iranian assets in late 1979. The increase in liability risk inherent in the rapid buildup of the accounts of an individual depositor required compensation in the form of below-market rates on those additional deposits. This held both for direct OPEC deposits and for the redeposits in U.S. banks of OPEC funds placed initially with non-U.S. banks. Since banks tend to view the marginal cost of funds as a blended rate, this availability of below-market funds to a relatively large number of banks in the 1979-81 period resulted in a significant tiering of effective marginal deposit rates. For the banks so favored, negotiated loan spreads thus understated the effective margins earned on loans and hence, the rewards entailed in assuming the risks perceived in lending to the developing countries.

The restraining influence on negotiated loan spreads of this form of deposit-rate tiering has disappeared with the rapid decline in the OPEC surpluses. Recently, however, a new concern promoting the tiering of deposit rates has emerged—the differential exposure of individual banks to Polish-asset risk.

The likelihood of continued tiering of deposit rates is of relatively little importance to the outlook for loan spreads to the developing countries, however. The key element promoting higher spreads is the need to involve an increasing number of participants in the loan syndication process, particularly for loans to the major borrowing countries. To the extent slow growth of domestic credit demand does not reduce the minimum return demanded on international lending by the historically less active institutions, they must be attracted into the market by higher spreads. When a country's borrowing needs are large, it is thus possible that spreads could be stable or even rising over a period in which the risk attached to lending to that country is generally perceived as falling.

This need to involve a larger number of financial institutions in international lending has relatively little to do with *changes* in perceptions of country risk. It is chiefly a matter of portfolio balance—the increased concentration of the debt of a relatively small number of major borrowing countries in the portfolios of the major international banks. Although the overall capital/asset ratios of the major U.S. banks have shown no tendency to deteriorate in recent years, the proportion of capital at risk in a number of individual borrowing countries has reached relatively high values. In part because of the stance taken by the regulatory authorities, these ratios will tend to increase much more slowly in the future than they have in the past. For the historically more active international banks, increases in exposure to the major borrowing countries will be more closely linked to increases in bank capital. Those countries with ambitious borrowing targets may thus need to tap institutions now outside the international market.

Most of the recent technical innovations in the international financial market can in fact be understood as a response to this need to involve a larger number of financial institutions in that market. Prime-based loans, syndicated bankers'-acceptance credits, floating-rate Euro-notes, and two-tranche loans with the short-term tranche aimed at regional banks, are all examples of this market response.

Lending-market ironies

That loan spreads to the non-oil developing countries should be expected to rise at a time when lower oil prices and lower interest rates hold out the prospect of improved debt-service capabilities is quite ironic. Overall, the net borrowing requirements of the non-oil developing countries are unlikely to increase significantly this year. Next year they are likely to fall somewhat. And although debt-service ratios will continue to rise for most nations in this group, the proportion of export receipts required to cover interest payments on net foreign debt could be close to peaking.

This more favorable outlook obviously does not hold across the board, however. The number of countries with debt-service difficulties serious enough to require debt rescheduling is growing. Furthermore, market perceptions of the risk inherent in lending to oil exporters with a high capacity for import utilization are increasing. Nonetheless, most of the major borrowing countries are importers of oil in significant quantities, and for these countries the perceived likelihood of debt-service difficulties is decreasing. Just the same, the spreads such countries will have to pay in order to cover their borrowing needs are likely to be higher in the near term than in the recent past.

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The French Franc Under Fire

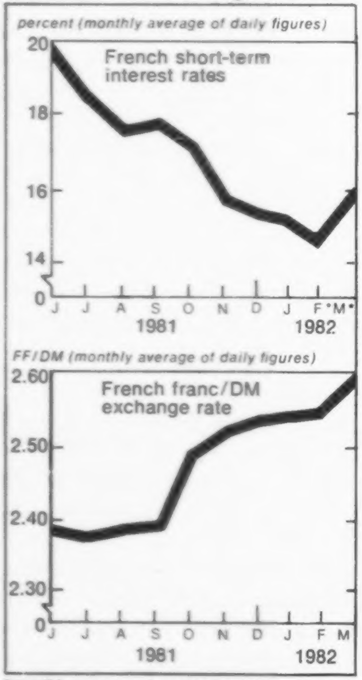
The French franc encountered enormous speculative selling pressure last month, hitting the intervention limits of the European Monetary System (EMS) in terms of both the German mark and the Dutch guilder. Four events appeared instrumental in sparking this latest bout of speculation. First, the February realignment of Belgian franc and Danish kroner parities switched focus onto the French franc as the next likely candidate for devaluation. Second, early budget estimates for 1983 showed an expected doubling of the FF 100 billion deficit likely to be registered this year. Third, France registered a trade deficit of FF 40 billion over September-February—twice the deficit of the prior six-month period. And finally, the swing against the government in the March local elections appears to have encouraged the belief that the Mitterrand administration may step up its reflationary program.

At that time, concerted European central bank intervention helped shore up the currency. The Bank of France itself reacted aggressively, raising its money market intervention rate to 18%—a six-month high. In addition, existing exchange controls were further tightened. Exporters must now repatriate foreign earnings within a 15-day interval, rather than the previously permitted period of one month.

Tighter monetary policy, however, is inconsistent with the expansionary aims of the French government. Moreover, it comes at a time when there is disturbing evidence that the nation's economic recovery is running out of steam: Consumer spending remains sluggish at best, despite increased social transfers. And private investment is still depressed, as firms face a severe financial squeeze in a period of great uncertainty. Foreign demand also remains weak, with the recovery in overseas markets now apparently postponed. These developments all throw doubt on whether France's official target of 3% growth in real GDP can be achieved this year.

If the government is to continue its attempts at reflation, it must break with the financial discipline that current EMS limits impose. It has several possible options. For example, policymakers could choose an early, but small, franc devaluation. This would permit some decline in interest rates but would also run the risk of renewed pressure later on. A more radical alternative might include either a widening of franc intervention bands, similar to those currently in effect for the lira, or the setting up of a two-tier exchange rate system along Belgian lines. Temporarily leaving the EMS altogther is perhaps the least likely option. But whatever path the government chooses, the status quo is unlikely to be maintained past the summer.

French interest rates and the franc exchange rate



*monthly average of weekly figures

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Canadian indicators spell recession.

The Canadian economy is in a distinct slowdown phase. Real growth advanced 3% for 1981 as a whole, but output has actually been falling since the third quarter. Declines have been notable in retail sales, autos, and durable equipment. Business profits fell 26% last year and investment spending is slowing. In March, the unemployment rate topped a 36-year high at 9%. Capital resources are also underemployed, with the industrial operating rate at 75% and inventories rising. The forces behind these various indications of recession include not only the U.S. recession, high interest rates, and persistent inflation expectations, but also the anticipation of further restrictive monetary and fiscal policies designed to produce a slowdown. Thus far, government efforts to bring down inflation have had only marginal success. Price increases through February have averaged 11.6% at an annual rate, compared with a rate of 12.5% at the end of last year. In this environment, the economy is expected to remain flat, at best, and may very well decline in 1982.

Projections of current-account surplus in 1982 help Finland cope with slower economic growth.

Finnish domestic economic activity remains quite strong by international standards. However, the overall pace of growth is slowing and there is rising concern about the prospects for employment over the next year and beyond. Unemployment is expected to exceed 6.5% this year, after rising to 5.3% in 1981 from 4.8% in 1980. The most recent 1982 economic forecast by the finance ministry predicts GNP growth of 1.6%—slightly less than the earlier forecast of 1.8%—and a continuing decline in Finland's export competitiveness, resulting from the country's 10% inflation rate. Nevertheless, the relatively slow rate of economic growth will limit the demand for imports. And as a result, the current account of the balance of payments is expected to show a surplus of 1.6 billion markka this year, compared with a deficit of some fmk. 1.7 billion in 1981. February trade figures—a surplus of some fmk. 685 million juxtaposed with the February 1981 surplus of only fmk. 31 million—indicate the turnaround is already under way.

Difficult policy choice ahead for Greek government if deficit fails to improve.

Greek Prime Minister Papandreou's socialist government unveiled its first budget last month. Despite a 35% increase in state expenditures, the document projects an improved deficit position in 1982—down to 9% of GNP from 12% in 1981. The government anticipates that hikes in indirect and corporate profit taxes, combined with a property tax, higher income taxes for top income earners, and tighter enforcement of tax collections will bolster revenues by some 59%. These revenue projections, however, may prove to be overly optimistic. Few private forecasters expect economic growth in 1982 to be as robust as the 2% the government is hoping for. Moreover, the official budget figures do not take into account the deficits of Greece's public corporations, which last year came to an estimated 3% of GNP. Failure to reduce the budget deficit would leave the authorities with an unpleasant choice between further squeezing the hard-hit private sector or raising credit expansion—a move that bears the threat of boosting the inflation rate well above last year's 25%.

Improvement in Israeli current-account gap expected in 1982.

Provisional estimates indicate that the current account (excluding transfers) of Israel's balance of payments in 1981 registered a deficit of $4.4 billion. While this amounts to a deterioration of some $550 million from the deficit registered in 1980, it is almost entirely explained by a $650 million increase in defense imports associated with the Negev military redeployment. In fact, the "civilian deficit" shrank by $100 million to about $2 billion last year. This represents a creditable performance in view of a further deterioration in the terms of trade. A surge in imports of consumer goods that followed a pre-election cut in purchase taxes was more than offset by a slump in diamond imports and a drawdown of oil stocks. And while the world-wide recession in the diamond industry constrained diamond exports, other industrial exports—led by minerals, metals, and electronics products—rose 17% in volume terms. Official forecasts look for some continuation in these trends over 1982. And with military imports expected to fall, an improvement in the overall current-account balance seems likely.

Chilean adjustment working, but costs are high.

Chile is adjusting to a current-account deficit that had been proving increasingly difficult to finance—by means of a domestic recession. Monthly import expenditures, according to registered intentions to import, have fallen sharply from an average of $600 million in the first ten months of 1981 to $370 million since then. Also, inflation continues to decelerate, supporting projections that by year-end the rise in the CPI will have slowed to about 3%. And, more importantly, wage costs are decreasing. This adjustment, however, is occurring at high social costs. Real GDP is likely to decline 3%-5% this year. This means not only that unemployment, which totalled 13.5% in December, may climb to 15%, but also that the number of bankruptcies will rise. Prospects are that Chile will not emerge from the present slump until early 1983. And even this forecast is dependent upon the assumption that the industrial economies will experience a recovery by the fourth quarter of 1982.

Philippine government reaffirms commitment to industrialization program.

The Philippine government remains steadfastly behind its ambitious industrialization program. The plan, which was drawn up in 1979, aims to reduce the country's dependence on labor-intensive industry through the construction by 1985 of eleven major projects, including: a copper smelter, a phosphatic fertilizer plant, an aluminum smelter, an integrated steel mill, and a petrochemical complex. Although several projects are underway, concerns have arisen over the availability of inputs and the attractiveness of final markets. Consequently, difficulties in lining up foreign investors have led to construction delays and several of the projects have been scaled back. Even the government admits that implementation of at least two of the projects—the aluminum smelter and the petrochemical complex—could be "difficult." Still, a recent study by the government's National Development Corporation estimates that if the projects are completed reasonably as planned, they could bring in close to $9 billion net in foreign exchange over the decade.

Singapore interest rates volatile, as monetary authorities grapple with policy dilemma.

Frequent monetary policy shifts have produced unusual interest-rate volatility in Singapore in recent months. Uneasy about persistently adverse international interest-rate differentials, the Monetary Authority of Singapore (MAS) in early March adopted a more restrictive money-market stance in an attempt to reverse a slowdown in the inflow of capital. As a result, domestic interest rates have risen in the past few weeks. Overnight rates, for example, climbed by more than 175 basis points to over 9% from about 7¼%. This then created concerns, not only for the effects on imports of a stronger Singapore dollar against the yen and European currencies, but also over what might happen to domestic demand, which had been instrumental in maintaining Singapore's 10% rate of economic growth in 1981 in the midst of a stagnant world economy. In response to these concerns, the MAS has now apparently softened its policy stance and has intervened in the domestic money market in order to bring interest rates back down.

Nigeria faces huge current-account deficit.

During 1981, Nigeria's oil output shrank 30% to 1.44 million barrels per day, as world-wide demand for oil declined. Nigerian oil revenues fell some 28% and the current account of the balance of payments swung from a $2.9 billion surplus in 1980 to an estimated $8.5 billion deficit in 1981. Uncompetitive pricing caused record-low oil sales and unsustainable losses in the first quarter of 1982. This forced the Nigerians to enact a virtual ban on imports, soon to be replaced by specific import controls. In view of the continuing glut on world oil markets and Nigeria's urgent need for oil revenues—which normally account for some 95% of total export receipts—it is difficult to envisage how current Nigerian oil prices can be maintained. Even under optimistic output assumptions for the latter part of 1982, total oil revenues for the year are not likely to exceed $15 billion. And under less favorable conditions they could fall as low as $12.5 billion. Consequently, the current account of Nigeria's 1982 balance of payments could register a deficit in the range of $9-12 billion.

Signs of Hope For a Spring Recovery

As expected, the first official estimate of real Gross National Product released last week showed another contraction in U.S. economic activity during the first quarter of 1982. Real GNP fell at an annual rate of 3.9%, which was not much different from the 4.5% rate of decline reported for the last quarter of 1981. Along with other recent statistics, this strongly implies that the economic recession continued at least through March.

However, the GNP report included some good news, too. Final sales of goods and services actually increased. The recorded fall in overall real output was attributable to inventory reduction—a process that may soon be completed. Moreover, price inflation, as measured by the GNP deflator, dropped to an annual rate of 3.6%. Except for one quarter in 1976, that was the lowest rate in about a decade. The deflator increased over 9% last year. Although a portion of this apparent improvement was a purely statistical phenomenon, owing to a change in the mix of output, most of it represented real progress.

The current U.S. recession began last August. Initially, the slump reflected a decline in consumption and investment, which was largely the result of tight money and high interest rates. Declining sales created an inventory excess that had to be corrected. It is the degree to which this correction has been accomplished—while final sales have actually began to recover—that is encouraging. Inventories were being expanded at a rate of $27.5 billion in the third quarter of 1981; they were reduced at a rate of $40 billion in the first quarter of 1982—an exceptionally large swing of $67.5 billion at an annual rate.

A clear majority of economic analysts expect the U.S. economy to begin recovering this spring; the major progress that has been made in bringing inventories back in line with sales is the best evidence yet that they may be correct. A rise of 1.9% in new orders for durable goods, following an increase of 3.5% in February, was also a favorable sign. The principal remaining concern is that real interest rates may remain high enough to stifle an improvement in investment.

The recent drop in the U.S. inflation rate has exceeded the hopes of all but the most extreme optimists. Every broad measure of U.S. price trends has weakened. The Consumer Price Index increased at a rate of under 5% in December, under 4% in January, and under 3% in February. Producer (wholesale) prices declined fractionally in both February and March. Some of the improvement is temporary, to be sure: Commodity prices have declined because of widespread world-wide recession; they will recover when the world economy expands. And petroleum prices won't go down forever. But other prices have also eased. And there are signs of spreading moderation in the rate of increase in wage rates. Thus, the gloomy news of continuing economic decline should not be allowed to obscure the more hopeful signals of improvement.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF				
		6 months ending	change from year earlier	in billions of dollars	per capita	latest date	reserves (less gold) in million $	12-month change	months of imports covered	use of credi lines of
Argentina	Economic uncertainty increases owing to Argentina-U.K. dispute.	Feb.	+ 9%	120.0	$4,263	Dec.	3,268	−51%	2.2	0
Barbados	Real GDP declines 1% in 1981 owing to downturn in tourism.	Sept.	−19%	0.9	3,644	Feb.	98	+28%	2.1	1
Brazil	Industrial activity at low levels; inflation rate slowly declining.	Dec.	+ 5%	284.8	2,307	Jan.	6,402	+16%	3.2	0
Chile	Recession intensifying as foreign credit inflows tighten.	Dec.	−19%	35.3	3,126	Feb.	2,982	− 5%	6.4	33
Colombia	Liberalized authorization allows companies to borrow funds from the international markets.	Sept.	−33%	37.3	1,399	Feb.	4,569	− 4%	10.1	3
Dominican Republic	Proposed Caribbean Basin Initiative will exempt 700 000 tons of sugar from U.S. tariffs annually.	Nov.	− 4%	7.3	1,314	Feb.	162	+10%	1.3	22
Ecuador	New multiple exchange rate system results in partial devaluation.	Dec.	0	13.8	1,676	Feb.	623	−22%	3.0	0
El Salvador	Substantial cotton and coffee production decline projected for 1982.	Aug.	−40%	3.3	666	Jan.	74	−39%	0.9	42
Honduras	Two new oil searches get underway in the southwest.	Oct.	0	2.9	762	Dec.	101	−33%	1.3	63
Jamaica	Bauxite production could fall to 8.5 million tons this year from 11.6 million in 1981.	Dec.	− 7%	3.1	1,360	Jan.	122	+ 1%	1.0	475
Mexico	Government approves additional wage increases of 10%-30%, despite business complaints.	Dec.	+25%	238.7	3,303	Dec.	3,972	+34%	2.4	0
Nicaragua	Foreign exchange certificates issued to stimulate exports—can be traded in parallel market.	Aug.	+54%	2.7	1,089	Sept. '79	87	+32%	1.1	23
Panama	Inflation rate falls to 5% owing to lower oil prices and reduced import costs.	Dec.	−32%	3.8	2,027	Jan.	104	+27%	1.0	90
Paraguay	Real GDP growth slowed to 8.5% during 1980-81 from 11.4% owing to export problems.	Dec.	−14%	5.4	1,664	Feb.	761	+ 2%	14.7	0
Peru	Agreement reached with IMF bodes favorably for improved demand management.	Dec.	−18%	21.0	1,160	Dec.	1,209	−39%	4.4	376
Puerto Rico	Decline of U.S. economy adversely affects island; unemployment reaches 22% high.	Nov.	+ 8%	11.7	3,658	Jan.	11,805	+20%	14.7	0
Uruguay	Economy is plunging into recession, as liquidity tightens and real interest rates rise.	June	+48%	10.9	3,711	July	403	− 5%	2.9	0
Venezuela	Government budget cut by $2 billion because of low oil revenues.	Dec.	+ 5%	69.4	4,494	Feb.	7,396	+ 5%	6.1	0

An Ill-Advised Proposal

The Federal Reserve is considering a change in the way it reports weekly money supply statistics. According to a recently announced proposal, which will not be voted upon for some weeks, the Federal Reserve would no longer report weekly averages of seasonally adjusted M1 numbers. Instead, it would release adjusted M1 figures as four-week moving averages, and report only unadjusted weekly average figures. The Federal Reserve is also considering releasing its money supply data later than the current 4:10 p.m. in the eastern time zone on Friday.

The Federal Reserve's consideration of these changes stems from concerns expressed by some Fed officials that the markets place too much emphasis on weekly money numbers. According to the Federal Reserve, publishing only the moving average of the weekly seasonally adjusted money data might be preferable in that "it would dilute the vast amount of 'noise' that is inherent in the individual weekly figure." It is widely recognized that the highly volatile weekly money numbers are poor indicators of the trend growth rate of M1, and that the method used to adjust the weekly M1 figures for seasonal variation is extremely imprecise.

The likely effect of this proposed change, however—if it is implemented—will be negligible. The Federal Reserve earlier this year released the weekly M1 seasonal adjustment factors it will use through the end of 1982. Thus, market participants will be able to compute the weekly seasonally adjusted figures from the raw data. And beyond 1982, Fed watchers will construct their own weekly seasonal factors.

More fundamentally, however, the apparent rationale for this proposed change is flawed. Market participants are not irrational in their reactions to weekly money numbers; rather, their response is consistent with the current operating strategy of the Federal Reserve. The behavior of the money supply has a major impact on the open market activities of the Fed, and, through these operations, on the federal funds rate. When a given weekly money number differs significantly from the markets' expectations, there is no sure way of telling how much of this change will be immediately reversed. Consequently, weekly changes in M1 affect the markets' best guess of the current month's M1 growth rate. And since experience indicates that monthly deviations of money growth from the Fed's targets often lead to changes in its reserves targets, weekly M1 figures affect expectations of the future level of the federal funds rate.

Rather than altering its money reporting procedures, perhaps the Federal Reserve would be better advised to release more information on its operating targets and policy intentions. The Federal Reserve's current short-run targets for various measures of bank reserves and the monetary aggregates, as well as for the trading range of the federal funds rate, are unknown. The timely reporting of these targets would better facilitate the market's difficult task of deciphering the current policy intentions of the Federal Reserve.

PAYMENTS		MONEY AND BANKING							COUNTRIES
IMF, mil- dollars		12-month changes				exchange rate in U.S. dollars	change from year earlier		
	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	April 21, 1982		current monetary conditions	
	Foreign exchange made available to pay non-U.K. obligations.	Feb.	+149%	Dec. '80	+95%	.000082	−80%	Liquidity eases with lower reserve requirement.	**Argentina**
	Consumer imports restricted.	Dec.	+ 12%	Dec.	+ 5%	.5200	0	Savings rate increased.	**Barbados**
	Lower oil import costs help produce trade surplus.	Jan.	+ 98%	Aug.	+58%	.0068	−50%	Ceilings placed on bank credit growth.	**Brazil**
	Huge narrowing of 1982 current-account deficit expected as demand contracts.	Feb.	+ 7%	Sept.	+17%	.0270	+ 5%	High real interest rates continue.	**Chile**
	Prior import deposits cut to 20% from 35%.	Dec.	+ 26%	July	+28%	.0210	+11%	Monetary Board provides more liquidity.	**Colombia**
	Foreign banks reach accord with central bank on commercial arrears.	Sept.	+ 8%	Dec.	+ 7%	Par	—	Monetary policy is restrictive.	**Dominican Republic**
	Oil exports decline in early 1982.	Dec.	+ 18%	Oct.	+23%	.0240	−36%	Money supply is severely restricted.	**Ecuador**
	Net international reserves were minus $260 million at end of 1981.	Dec.	+ 12%	Nov.	+ 7%	.4000	0	Interest rates raised to stem capital flight.	**El Salvador**
	IMF approves $27 million credit to cover drop in coffee and banana exports.	Nov.	+ 10%	Dec.	− 1%	.5000	0	Deposits down 10% in 1981.	**Honduras**
	U.S. agrees to buy 1.6 million tons of bauxite for its strategic stockpile.	Dec.	+ 5%	Nov.	−16%	.5700	0	Monetary stance remains restrictive.	**Jamaica**
	Mexican travel abroad declines after devaluation.	Jan.	+ 31%	Nov.	+40%	.0220	−47%	Central bank attempts to reduce interest rates.	**Mexico**
	Levy on non-traditional exports raised to help meet debt-servicing needs.	July	+ 28%	July	+38%	1.4930	n. a.	Net foreign assets falling.	**Nicaragua**
	Canal tolls to be raised almost 10%.	Jan.	+ 5%	Dec.	+10%	Par	—	Domestic loan growth is strong.	**Panama**
	Exchange rate devalued for certain exports.	Sept.	+ 10%	Oct.	+ 8%	.00795	− 1%	Money-supply growth restricted.	**Paraguay**
	Toquepala mine expansion delayed.	Oct.	+ 73%	Sept.	+41%	.00169	−35%	Zero credit growth to public sector expected.	**Peru**
	Tourist spending below normal.	Jan.	+ 7%	Jan.	+14%	Par	—	Decline in private savings accounts.	**Puerto Rico**
	Import restrictions being tightened; 1985 average tariff duty will be over 35%.	Aug.	+ 33%	Dec.	+ 7%	.0890	−10%	Deposit rates lowered to 40%-43%.	**Uruguay**
	Oil production to be cut to 1.5 mbd, lowering exports to 1.1 mbd.	Dec.	+ 11%	Oct.	+ 7%	.2330	0	Foreign reserves down $800 million since December.	**Venezuela**

World Interest Rates

market rates as of April 21, 1982; bond yields as of April 16, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	15.34	12.979 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.00	5.50	5.50
Day-to-Day Money	14.75 April 22	15.50	13.00	13.50	16.50	9.45	20.375	7.50	3.25* 1-month Euro-Swiss fr. rate	7.125
Treasury Bills 91-day, Middle Rates	12.22 discount basis	14.95	13.00	15.00	n. a.	n. a.	17.90 70 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	13.50 finance paper discount basis	15.45 finance paper 15% tax w/h	12.233	13.90 Certified	16.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.75	15.50 15% tax w/h	12.9375	13.90 Certified	not traded	9.40	21.60	no market	5.125	no market
Government Bonds Long-term, new and old issues, average yield	13.48	15.375	13.87	10.80 20% tax w/h	16.065	8.98	20.35	10.21	5.07	7.29
Industrial Bonds prime, long-term, new and old issues, average yield	14.85 Aa Industrials	15.75	15.02	15.51	17.06	8.97	20.42	11.22	6.01	6.57
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	17.00	14.00	17.50	18.50	13.00	21.75 ⅛ qtrly fee on outstdng.	11.00	9.50	6.00
Bank Time Deposits 3-month	14.00 Cert. of Dep.	14.3125	13.6875	14.65	16.25	9.05	11.50	8.125 large deposits	4.75 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	15.00	15.625	13.8125	no market	23.25	8.9375	no market	8.0625	5.00	6.875
Exchange Rates—in U.S.$ rates floating against the $	—	.8175	1.7790	.022	.1605	.4178	.000759	.3770	.5105	.004127
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	.587 *D*	1.468 *P*	2.945 *D*	7.995 *D*	6.030 *P*	8.443 *D*	6.897 *P*	10.064 *P*	8.058 *P*

Eurodollar Deposits

(London, interbank, bid)
April 22

7-day	14.8125
1-month	14.875
3-month	14.875
6-month	14.875

International Arbitrage

(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.068
U.S.-Canada Treasury Bills	−1.433
U.S.-Canada Finance Co. Paper	−1.151
Eurodollars-U.K. Local Auth. Deposits	− .030

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	14.375*
Over 7 yrs.	14.625*
DM Bonds	
7 yrs. and under	9.00*
Over 7 yrs.	9.25*

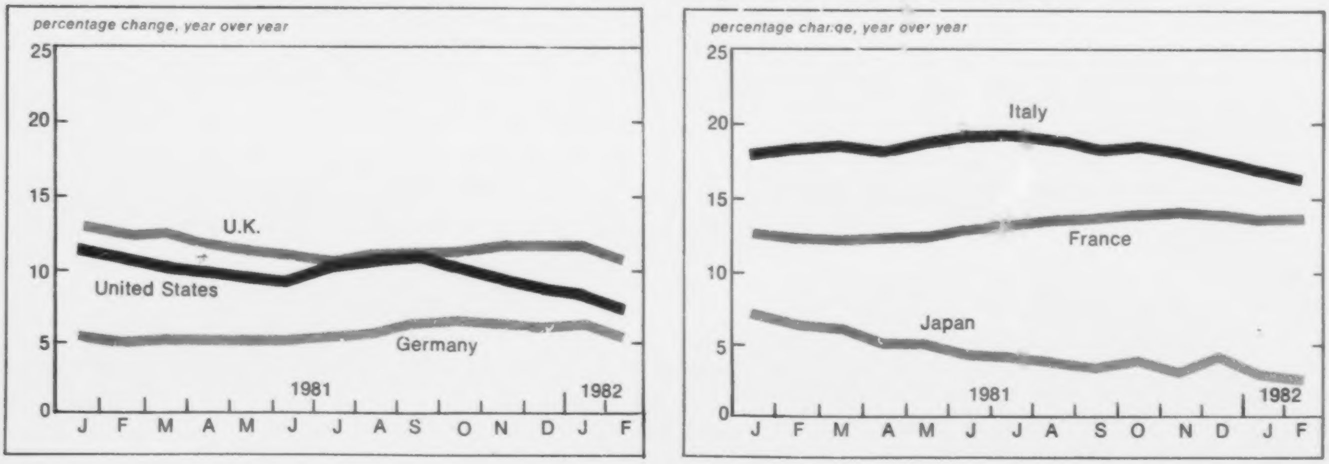
Gold Price

London
afternoon fixing

344.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
*Market rates as of April 14, 1982.

Consumer price trends in major industrial countries



Bermuda: International Business Lends Support

Bermuda—a scenic and sunny archipelago, set in the Western Atlantic about 600 miles off the eastern coast of the United States—is a place where thousands of tourists come each year to forget their troubles. In the years when the vacationers do not come, however, this resort colony has a few economic troubles of its own. Last year was one of those years.

Buffeted by domestic labor strikes, world recession, and sharp increases in hotel costs and airfares, Bermudas' tourism industry suffered one of its worst years in recent history. And for the time being, the tourism slump has stalled the rapid economic growth enjoyed by Bermuda in recent years. Nevertheless, the economy as a whole is far better equipped to weather the current slowdown than in previous years, owing to a substantial buildup in the islands' international business sector.

As a high-income, tourism-based British colony, Bermuda has undergone exceptional economic growth over the last half-decade. Since 1976, GDP has doubled in current dollar terms, reaching $725 million in 1981. With a population of about 55,000, this amounts to an annual per capita income of over $13,000. Bermuda's agricultural and industrial sectors are small, and the bulk of its income—some 85%—comes from tourism and international business.

Tourism, by far, remains the predominant industry in that it brings in about 60% of the colony's annual foreign exchange earnings and employs about three-fourths of the work force. As a result, fluctuations in the tourist trade have produced variations in real GDP during the past few years. But the increased presence of the international companies has helped to temper the impact of the downswings in visitors. Real growth in fiscal year 1979-80 measured 6.5%, as tourist income increased strongly. With the slowdown in tourism revenues begining in 1980-81, however, economic growth decelerated to 4.8%. Official statistics for the just-ended fiscal year 1981-82 are not yet available, but indications are that real GDP registered a modest decline.

Tourism down sharply

Bermuda's tourism sector has undergone a severe contraction over the last year, falling to its lowest level since 1975. Overall tourist arrivals shrank by about 12% in 1981. The volume of visitors from the United States, which comprises about 88% of the total number of tourists annually, was off by a similar amount. And vacationing visitors from Canada, Great Britain, and other European countries fell far short of their 1980 levels. Thus far in 1982, the tourism slowdown has shown no improvement. Through February, the number of visitors was some 28% below the already depressed level for the comparable period in 1981.

To some extent, Bermuda's downturn in tourism reflected the recession in the United States and other parts of the world. But the unusual severity of the decline was more the result of domestic economic events. In May of 1981, Bermudan hotel employees and taxi drivers went out on strike in a demonstration of sympathy with striking government blue-collar workers. The strike lasted four weeks and forced the closing of all but one of the islands' ten largest hotels. Coming as it did during tourism's "high season," the strike resulted in a 90% drop in the number of tourists usually expected during this period. For the Bermudan economy, this meant a loss of some $30 million, or nearly 5% of national income. By the time the strike was settled, tourism had been seriously affected. And because the labor difficulties came at a time of economic recession in the United States, future visitor bookings were depressed even further.

The overall economic impact of reduction in Bermuda's tourist earnings during 1981 was partially offset by the activities of international business and services companies. Attracted by favorable tax arrangements, good communications, and strong support services, international firms located in the islands in 1981 totaled some 5,000—a 25% increase from just three years earlier. The operations of these firms—known as "exempt" companies—are outside of Bermuda. They cover a range of international activities, but the so-called "captive" insurance and reinsurance companies are the dominant exempt group. These are the insurance subsidiaries of leading multinational corporations, most of them U.S.-owned. In addition to insurance firms, Bermuda's international businesses include principally shipping and private trust companies. As a sector, international business contributes about one-fourth of the colony's foreign exchange earnings and approximately the same share of GDP.

The outlook

The prospects for an economic revival in Bermuda in the current fiscal year 1982-83 will depend on the recovery of income growth in the U.S. and Canadian economies, as well as on specific tourist industry influences such as hotel rates, room capacity, and airfares. The country's rate of inflation has moderated substantially—down to an annual rate of 9.4% in February from a peak of 15% in February 1980. This should help to ease any local cost pressures. But with annual imports equal to two-thirds of GDP, any further improvement in the Bermudan price level will be dependent upon changes in inflation in other parts of the world. Nevertheless, with the activities of the international companies holding steady, the resort economy should regain its momentum once U.S. and world economic conditions improve.

A. Blake Friscia

Managing Interest-Rate Risk

The recent volatility and unpredictability of U.S. interest rates have made corporations increasingly sensitive to the costs associated with interest-rate risk. Many firms have initiated short-run financial management programs to reduce the perceived risks, and many more firms are contemplating complex short-run hedging strategies using financial futures, as well as traditional asset and liability exposure management techniques.

Such short-run interest-rate risk management programs raise several critical corporate issues. The first is the question of whether interest-rate risk is really interest-rate risk. In the short-run, probably yes, but in the long-run interest-rate risk begins to mirror inflation risk. This leads to a second consideration, that of short-run versus long-run financial strategies. If long-run inflation exposure is best hedged with floating-rate debt, as much research suggests, then a short-run hedging program may be counter-productive. That is, firms may simply be trading short-run risks for different long-run risks. With this in mind, a third point arises concerning which risks the firm's stockholders would prefer to have managed. The answer is not always clear. For many firms, short-run interest-rate hedging programs are clearly essential to long-run survival, but for others this is less the case. A well-structured financial risk management strategy needs to recognize these points explicitly.

Interest-rate and inflation risk

A necessary first step in analyzing financial risk is to distinguish between the long-run and short-run relationships among interest rates, inflation, and the dynamics of financial markets. Over the long run, expected inflation is the principle determinant of nominal interest rates, as can be easily seen from the following table comparing the low interest rates and low inflation rates of the 1950s and 1960s with the higher inflation and interest rates of the 1970s.

The long-run inflation/interest-rate relationship
(percent, annual averages)

	1951-60	1961-70	1971-80
Inflation rate (CPI)	1.4	3.0	10.4
U.S. Treasury bond yields	3.2	4.9	8.0

Investors generally seek an adjustment, or premium, for anticipated inflation in the nominal returns they receive, so these variables will move together over extended periods. Thus, over the long run, interest-rate risk reduces to a more fundamental "inflation risk."

In the short run, inflation expectations have less meaning as a guide for investors seeking to preserve their real rates of return. Rather, movements in interest rates become dominated by changes in monetary and fiscal policies—and by expectations as to those policies—through the dynamics of financial markets, well before the effects of these policy changes are felt in the price level. Over this short run—which may comprise weeks, months, or even years, if the policy change is dramatic and the adjustments required are large—interest-rate risk may be appropriately distinguished from inflation risk.

A corporate perspective

A corporate financial risk-management strategy, for both the short run and the long run, should be formulated in the context of these separate inflation and interest-rate risks. It may be possible, for example, to build a natural long-run hedge against inflation risk into the debt structure of a corporation with the use of floating-rate debt. If a firm's earnings tend to keep pace with inflation, then in the long run the firm's gains from inflation on the earnings side will offset higher interest expenses. Such a firm may wish to use floating-rate debt for this feature, which produces a long-run trade-off between interest rates and inflation. This is in contrast to fixed-rate debt, which is essentially a bet against inflation rather than a hedge against its fluctuation.

Of course, the firm's ability to manage long-run inflation risk in this manner requires that it be able to weather substantial financial disturbances in the short-run. To determine whether it is sufficiently robust, the firm must assess its short-run interest-rate risk relative to its capital base, business plan, and anticipated cashflows. The firm must consider a variety of possible interest-rate scenarios and the probabilities associated with each. Then the firm is in a position to evaluate the implications for its bottom line in each case.

Essentially, there is no point in managing interest-rate risk unless the firm is vulnerable in the short run. In addition, it should be noted that hedging short-run interest-rate risk may mean that the firm will not benefit from any long-run offsets between interest rates and inflation. That is, if floating-rate debt is hedged in the short-run for interest-rate risk management purposes, then the benefits of the floating-rate debt and inflation trade-off may be missed, since turning points in interest rates are notoriously difficult to call. Thus, it is critical for the opportunity costs of short-run management to be fully recognized in a long-run perspective. From a stockholder's point of view, short-run interest-rate risk management may be more costly than it appears month to month to the business manager, if long-run issues are ignored.

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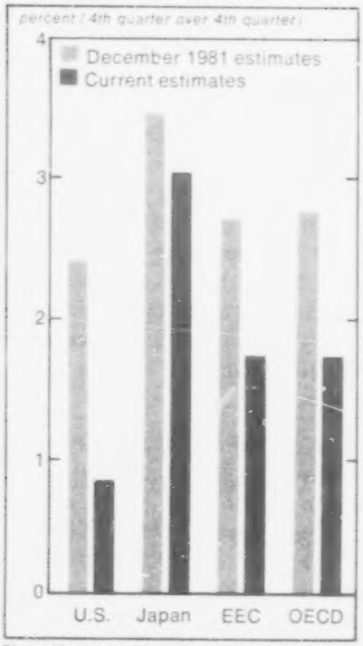
A Worsened Global Outlook for 1982

The prospects for the growth of the world economy in 1982 have deteriorated significantly since the beginning of the year. The recent reduction in the OECD Secretariat's forecast of aggregate growth in the OECD economies this year to 0.3% from 1.25% on a year average basis is but the latest in a steady progression of increasingly pessimistic projections. This shift in outlook applies for virtually every major economy, but the magnitude of change is largest for the United States: Last year most forecasters projected a rebound in the second half of 1982 sufficient to result in U.S. economic growth of at least 2.5% on a fourth-quarter-to-fourth-quarter basis. Today only the most optimistic are forecasting growth at much more than 1.5% over that time period, and an even lower rate is likely. Growth forecasts for the European economies have also been scaled back, particularly those for Germany and Italy, but the majority view is that for Europe, the change from earlier projections will be less than for the United States.

The usual explanation for this change in outlook is the unexpectedly high level of U.S. interest rates and the unwillingness of authorities in other countries to relax monetary policy in advance of a significant fall in those rates. The first quarter backup of U.S. rates, even in the face of rapidly falling inflation, and the relative stickiness of rates in Europe (Switzerland excepted) and Japan have undoubtedly led to lower growth expectations, and hence, to lower-than-expected consumption and investment expenditures. However, other forces have also been at work. One is the apparent slowdown in import demand—particularly for capital goods—by the developing economies. Another is the continuing failure of real wages in many economies to adjust to the changes in labor productivity implied by past shifts in the price of energy.

Even though growth projections for this year have been greatly reduced, the chances for forecasting error still seem one-sided. Lower-than-forecast growth appears more likely than growth at rates above current projections. The main source of this asymmetry is the possibility of a large temporary increase in personal savings rates in economies similar to the United States, where inflationary expectations are falling much more rapidly than interest rates. If there is a silver lining to this disquieting outlook, it is that a disappointing growth performance this year would appear to enhance the likelihood that the turnaround of the world economy, when it occurs, will be followed by a period of relatively sustained recovery.

Changes in projected 1982 growth rates *



* Chase Manhattan Bank Economics Group estimates

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Falkland Islands crisis overshadows Britain's economic progress.

The Falkland Islands crisis has come at an awkward time for the British government. Just as the economy was showing signs of responding favorably to the tough medicine administered over the last two-and-a-half years, the pound has come under some selling pressure and domestic interest rates have risen. Recent statistics have been reasonably favorable. Industrial production has stopped falling while the total number out of work has begun to decline. Inflation has begun to fall sharply—consumer prices in March increased 0.9%, bringing the year-on-year rate down to 10.4% from January's 12%. Perhaps more important, the underlying trend of earnings increases is running at about 7% per year while large increases in productivity have kept the increase in unit labor costs in manufacturing for the year down to a tiny 2.9% as reported in February. All of this suggested reasonable pound strength that would have given the government room to reduce interest rates as time went by. A long drawn out dispute might further weaken the pound and diminish Britain's economic prospects. Nevertheless, the markets are still hoping for an early settlement which would allow the economy to continue along the rather encouraging path of recent months.

Improvements in current account and inflation suggest further easing of German interest rates.

Economic activity in Germany continues to be sluggish. While industrial production showed small rises in each of the past two months, the index is still below the level of last autumn. Furthermore, domestic industrial order volume fell sharply in February while foreign order volume appears to be leveling off after rising dramatically in the second half of last year. On a more optimistic note, both inflation and the balance of payments have improved substantially. Consumer prices rose at a seasonally adjusted annual rate of just over 3% in the first quarter, and the April year-over-year rate fell to 5.1%. The current account of Germany's balance of payments showed a surplus of 2 billion DM in March, versus a deficit of 3 billion DM in March of 1981. These developments, together with the 4.2% wage settlement recently obtained in Germany's key metalworking industry, portend a further relaxation of interest rates in the coming months.

Mexican government enacts deficit-reducing program in support of peso devaluation.

The Mexican government has reaffirmed its commitment to trim the public sector deficit in support of February's devaluation of the peso. A new economic adjustment program has set a goal of reducing the deficit in relation to GDP by three percentage points; last year's deficit was 14% of GDP. To achieve the new target, controls and surveillances have been placed on government expenditures and some public works projects will be postponed. In addition, to help increase revenues, upward adjustments are being made in public sector prices, tariffs, and tax rates. The central bank is assisting the program by limiting credit to the government and thus, restricting the growth of the money supply. Overall, the Mexican authorities have a tough assignment. Since the devaluation, inflation has already jumped up to almost 35% at an annual rate—from 29% at year-end 1981—with further increases expected this year. The needed reductions in public spending and credit should help deflect price pressures but they are also likely to mean slower economic growth.

Puerto Rico suffering side effects of U.S. slowdown.

The Puerto Rican economy is experiencing one of its weakest periods in post-World War II history—primarily because of the U.S. recession. Tied closely to U.S. industrial activity, manufacturing output in Puerto Rico declined about 2% from July 1981 through February 1982. In addition, Puerto Rico has been hard-hit by changes in U.S. federal programs, especially the loss of CETA funds for public sector employment. This helped push the unemployment rate to over 22% in January 1982, although by March it dipped slightly to 21.9%. Furthermore, high interest rates have inhibited new construction activity on the island. A falling rate of inflation has helped to mitigate their impact in recent months, however. Through February, the consumer price index was down to an annual rate of only 6.6%. But while lower inflation will help to limit the decline in real terms, the outlook for the rest of the year suggests the economy will remain in a severe slump.

Italy's tighter exchange controls provide little relief for downward pressure on the lira.

Downward pressure on the Italian lira within the European Monetary System (EMS) prompted the Italian authorities to tighten exchange controls on April 19. The new measures reduce the period allowed for accepting payment in foreign currency for exports to 60 days from 120 and curtail payments in advance for imports. Included among those economic forces underlying the recent speculative pressure are the persistently wide differential between Italy's rate of inflation and inflation rates in some of the country's major trading partners such as Germany and a near doubling of Italy's trade deficit in February to some 2.9 trillion lire. In addition, recent downward pressure on the French franc was transmitted to the lira as foreign-exchange market participants expected—probably correctly—that any adjustment of the French franc/DM rate would be accompanied by a downward adjustment of the lira/DM rate. Thus, while the Italian authorities appear to wish to avoid a unilateral devaluation of the lira's central EMS rate, a general realignment of EMS rates involving the French franc/DM rate is highly likely to include a similar adjustment for the lira.

Bangladesh to receive new aid inflows; balance-of-payments funding still tight.

Bangladesh's major aid donors recently pledged new aid totalling SDR 1.42 billion (about $1.6 billion) for the fiscal year 1982-83 beginning in July. These commitments show a respectable 14% increase in SDR terms from the level of a year before but only a 4% increase in dollars, because of dollar appreciation. Quick disbursements of food and commodity aid will make up some $550 million of the assistance, while project aid will account for the remainder. Combined with the existing aid pipeline, these new commitments are expected to result in an increase in net aid disbursements to perhaps $1.3 billion from just under $1.2 billion in the current year. Nevertheless, the country's export prospects remain relatively poor. And unless additional aid is forthcoming, the government will have to keep a tight rein on imports, just to be able to finance its balance-of-payments funding gap, much less build up reserves from their present low level.

Indonesia contemplating change in exchange-rate policy.

Indonesia's central bank is considering a change in the way in which the rupiah is valued against other currencies. Currently, the rupiah is effectively pegged against the U.S. dollar. And from November 1978 (when the rupiah was devalued by more than 33% from 415 to 625 against the dollar) until last fall, the rupiah/dollar rate remained essentially fixed. Over the past six months, however, out of concern for Indonesia's deteriorating trade balance, central bank authorities have been allowing small but frequent slippages. In effect, the bank now sets exchange rates daily. From December 1 through the end of April, the rupiah declined 2.8% to a level of 652 per dollar. The proposed change in exchange-rate policy would revive the idea of a basket-currency valuation, with major weight given to the DM and the yen as well as the dollar, and would allow some floating, subject to government intervention. This would give the government greater flexibility, in that if other currencies in the basket weakened relative to the dollar, the rupiah would also be allowed to similarly depreciate.

Further erosion of Kuwaiti current-account surplus expected.

Kuwait registered an estimated current-account surplus of $13.2 billion last year—down substantially from nearly $17 billion in 1980. The drop was mainly due to a sharp decline in merchandise export revenues, from $21.1 billion in 1980 to an estimated $16.9 billion last year, owing to lower gross oil exports which accounted for 85% of these earnings. Although Kuwait's average official oil price (not including additional premiums) rose by nearly 18% in 1981 to $35.08 per barrel, its oil output fell by nearly one-third to 1.12 million barrels per day. Soft oil market conditions so far this year have already forced the country to cut its official price to $32.30 per barrel and to reduce its output further to around 775,000 b/d currently. Higher world demand for OPEC oil after mid-year will probably allow Kuwait to raise its output somewhat and should prevent further official price erosion. But oil revenue will again fall sharply during 1982, pushing this year's current-account surplus down to $6.5-8.0 billion.

Indexed Bonds May Open Up the Bond Market

After receiving some attention in other countries, indexed bonds may soon be finding their way into U.S. markets. A bill has been introduced in Congress that would authorize the Treasury to issue 20-year bonds that would pay a fixed interest rate on a principal indexed to the GNP price deflator. If successful, the instrument could be used by private corporations as well.

The current interest in indexed bonds stems from the poor performance of the bond market during a period of dramatically decelerating inflation. Because of stubbornly high nominal long-term interest rates, corporations have been reluctant to borrow funds that would commit them to large interest costs over a long period of time. Moreover, owing to concerns over the impact of burgeoning debt-service costs on the federal deficit, Congress recently failed to extend the Treasury's exemption from the 4¼% coupon ceiling on 30-year bonds. As a result, the Treasury's May 15 refunding will not include a long-term bond issue.

Proponents of the indexing idea contend that indexed bonds would allow the Treasury to issue low-coupon long-term bonds and reduce its sizable debt-servicing costs and the resulting budget deficit, especially if inflation continued to fall. In addition, they argue, by reducing the level of interest rates, indexed bonds could enable corporations to tap long-term debt sources and lengthen the dangerously short maturity structure of their current debt obligations.

Indexed bonds have some characteristics in common with some of the already-existing debt-instrument innovations implemented in recent years by corporations. Similar to floating-rate bonds, the actual magnitude of the interest costs over the life of the bond would not be known at the time of issue. However, unlike those instruments, the size of the principal would also be unknown. Furthermore, like deep-discount issues, such as zero-coupon bonds, debt-service costs would be small relative to the final return of principal, although indexed bonds would not lock the issuer into the high interest rates that the deeply discounted instruments entail.

An example may clarify the impact of indexed bonds on interest rates. If investors expect 10% inflation annually over the life of a bond and require a 3% real return for the use of their money, conventional bonds would need to yield 13.3%—10% to ensure the purchasing power of their principal, 3% real return, and 0.3% to restore inflation's erosion of their real return (10% of 3%). With indexed bonds, however, the yearly interest rate would be set at 3%; if inflation over the year turned out to be 10%, the principal would also increase

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981 (est.)		BALANCE OF PA				
			6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IM credit, mi lions of doll
Africa	**Algeria**	New regulations approved concerning joint ventures between Algerian and foreign companies.	Jan.	−17%	36.0*	1,935	Mar.	3,558	+2%	4.5	0
	Angola	Materials and equipment shortages plus internal transport problems hamper industrial production.	n. a.	—	3.9	525	n. a.	—	—	—	—
	Congo	Development plan for 1982-86 emphasizes infrastructure.	n. a.	—	1.2	735	Dec.	123	−44%	n. a.	0
	Egypt	Public sector expenditure rising on development projects.	Dec.	−11%	22.7*	535	Jan.	1,354	−35%	1.4	88
	Gabon	Budget for 1982 shows 18% increase in volume terms for investment outlays.	Dec.	+10%	3.4	6,180	Dec.	199	+85%	3.5	13
	Kenya	U.K. $44 million financing package will modernize Mombasa port facilities.	Aug.	−6%	8.0	500	March	204	−55%	1.3	260
	Mali	Cereal crop in 1981/82 up 30% from previous season.	n. a.	—	0.8	120	March	19	−27%	n. a.	7
	Morocco	New IMF loan program for 1982 includes credits of $580 million.	Nov.	−1%	18.1*	896	Feb.	29	−65%	0.1	422
	Niger	Revenue shortfall expected to cause cutbacks in public sector investment projects.	n. a.	—	2.2	410	Jan.	104	−16%	n. a.	0
	Nigeria	Euro-credit for $250-million being negotiated for fourth leg of railway to mining region of Ajaokuta.	Jan.	−36%	86.8	1,125	Feb.	2,620	−71%	1.5	0
	South Africa	Pressure on profit margins in manufacturing sector dampens investment plans.	Feb.	−26%	81.9	2,720	March	648	−46%	0.4	0
	Tunisia	Joint investment bank—capitalized at $95 million—set up with the United Arab Emirates.	Dec.	+2%	8.6*	1,350	March	527	−1%	1.8	0
	Zimbabwe	Price freeze replaced by system of price controls.	Aug.	+22%	6.2	815	Sept.	200	−37%	1.6	—
Middle East	**Kuwait**	Budget deficit of $1.1 billion officially forecast for 1982/83, vs. surplus of $2.7 billion in 1981/82.	Jan.	−26%	26.5	18,070	March	3,613	−6%	6.8	0
	Oman	Increase of 35% in oil export revenues last year fueled brisk pick-up of economy.	Jan.	+20%	4.8*	5,380	Jan.	1,079	+23%	8.3	0
	Qatar	Inflation rate for 1981 officially put at 8.5%, up from 6.8% in 1980.	Jan.	−19%	5.0*	23,100	Sept.	347†	−10%	3.4	0
	Saudi Arabia	Budget for 1982/83 projects expenditure of $92 billion, up 5% from previous fiscal year's allocation.	Jan.	−3%	117.6*	14,050	March	33,112†	+13%	12.3	0
	United Arab Emirates	Federal budget projects 1982 outlay of $6.1 billion, down 15% from 1981.	Dec.	−10%	19.4*	23,000	March	2,918†	+25%	4.4	0

*1980 †Excluding state reserves

by 10%, and the 3% interest rate would be applied to the higher principal. This would yield the same interest payment as the conventional bond. The difference would be that the indexed bonds would eliminate inflation risk to investors. (If inflation exceeds 10%, investors in conventional bonds receive a real return less than 3%.) Consequently, these instruments should attract investors into the long-term market. Moreover, from the issuers' point of view, should inflation turn out to be less than 10%, they will not be committed to high interest rates. This removal of the need to forecast inflation from both sides of the market is, in general, likely to result in lower nominal interest charges to the extent that current interest rates on conventional bonds carry an inflation-risk or volatility premium.

There are, however, disadvantages to indexed bonds, as well. First, if inflation does accelerate again, issuers could face a massive refinancing problem when the principal comes due. In particular, if a firm's product prices and nominal cash flow do not keep pace with the inflation index, it could face a future financial crisis if it issues indexed bonds now. Of course, this possible outcome needs to be weighed against the current, certain alternative of high interest costs and a heavy burden of short term debt.

Second, the tax treatment of indexed bonds has not yet been clarified by the Internal Revenue Service. In the case of zero-coupon bonds, it ruled last year that the annual increase in the value of the underlying bond is considered as a capital gain, despite the fact that the instrument generates no cash flow to the investor. Already there are some indications that the incremental increases in principal generated by indexed bonds might be regarded as dividend payments and taxed as ordinary income. The bill authorizing the Treasury's issue, however, has stipulated that indexed increments of principal be defined as non-taxable preservation of capital. A favorable resolution of this issue is crucial to the encouragement of investor demand for the instrument.

The final reservation about indexed bonds often voiced by critics is that they represent a surrender to inflation. Citing the use of such indexed contracts as labor agreements in many Latin American countries that have been unable to control their inflation rates, the opponents argue that indexed bonds present a mechanism for living with inflation rather than reducing it. However, since the Treasury would issue the first indexed bonds, the effect might well be just the reverse. By exposing itself to a potentially large liability if inflation is not controlled, the government expresses confidence that future inflation rates will recede. In fact, indexed bonds will provide the government with an incentive to actively pursue non-inflationary policies, especially after 1985, when indexation of the tax structure will eliminate the disproportionate gains in revenues the government enjoys from inflation-induced bracket creep. Moreover, by reducing the federal deficit and lowering interest rates, thereby encouraging private capital formation, indexed bonds make future disinflation all the more likely. *Carl Alan Batlin*

AYMENTS		MONEY AND BANKING							COUNTRIES
F l- ars		12-month changes				exchange rate in U.S. dollars	change from year earlier		
	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	May 5, 1982		current monetary conditions	
	Japanese awarded $250 million contract to build a new LPG plant.	Dec. '80	+ 10%	Nov.	+ 18%	.2235	— 8%	Money supply growing more slowly.	**Algeria**
	Better harvests this year should lower import bill.	n. a.	—	—	—	.0330	n. a.	Foreign exchange availability tight.	**Angola**
	Oil shipments in 1981 earned over $900 million—90% of total exports.	June	+ 16%	Dec.	+ 38%	.00332	— 9%	Net foreign asset position continues to strengthen.	**Congo**
	First quarter oil output averaged 670,000 b/d vs. 635,000 in previous period.	Dec.	+ 10%	Jan.	+ 30%	1.2200	— 16%	Money supply growing steadily.	**Egypt**
	OPEC imposes 150,000 b/d oil production ceiling, equal to 1981 daily average.	July	+ 7%	Dec.	+ 22%	.00332	— 9%	Credit remains available.	**Gabon**
	Manufactured exports benefit from improved availability of imported inputs.	Dec.	+ 19%	Feb.	+ 8%	.1102	— 4%	Government borrowing from central bank slows.	**Kenya**
	Lower cotton output affects exports adversely, but gold exports rise.	Dec.	+ 15%	Nov.	0	.00162	— 11%	Return to franc zone by year-end likely.	**Mali**
	Trade deficit in 1981 was $1.8 billion, up from $1.4 billion in 1980.	Nov.	+ 13%	Nov.	+ 14%	.1870	— 12%	France providing $207 million aid this year.	**Morocco**
	Uranium price weakness points to further decline in export receipts.	Dec.	+ 24%	June	+ 15%	.00332	— 9%	Net foreign assets decline.	**Niger**
	Pre-shipment import inspection extended to cover all imports over ₦ 5,000.	June	+ 24%	Dec.	+ 8%	1.4940	— 16%	Foreign exchange shortage is now acute.	**Nigeria**
	Ban lifted on U.S. non-military sales to S. African govt., police, and military.	Feb.	+ 14%	Jan.	+ 26%	.9500	— 21%	Financial rand discount shrinks markedly.	**South Africa**
	Earnings from tourism were $547 million last year, up marginally from 1980.	Dec.	— 11%	Jan.	+ 23%	1.7700	— 16%	Arab-African International Bank opens offshore banking unit.	**Tunisia**
	Preferential trade agreement with South Africa extended indefinitely.	Sept.	+ 15%	Sept.	— 8%	1.3570	n. a.	Foreign currency allocations to commercial sector reduced.	**Zimbabwe**
	Oil output in April reported at 775,000 b/d, down sharply from 1981 average.	Dec. '80	+ 9%	Jan.	+ 101%	2.5050	— 31%	Money supply growing more slowly.	**Kuwait**
	Oil output averaged 328,000 b/d in 1981, up 15% from previous period.	n. a.	—	Nov.	+ 26%	2.8960	0	Bank credit to private sector rising steadily.	**Oman**
	Drop in oil output forces sharp cut in LPG exports.	n. a.	—	Sept.	+ 17%	.2747	0	Claims on private sector rising steadily.	**Qatar**
	Aramco oil output reported below April ceiling of 7 million barrels per day.	Dec.	+ 3%	Sept.	+ 17%	.2920	— 2%	Riyal adjusted down to 3.43 per dollar from 3.42.	**Saudi Arabia**
	Dubai's imports totalled $5.4 billion last year, nearly unchanged from 1980.	n. a.	—	Jan.	+ 22%	.2735	0	UAE foreign aid to be cut 50% this year.	**United Arab Emirates**

World Interest Rates

market rates as of May 5, 1982; bond yields as of April 30, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	15.23	13.00 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.00	5.50	5.50
Day-to-Day Money	15.00 May 6	15.50	13.00	13.95	16.625	9.50	20.375	9.00	3.75 1-month Euro-Swiss fr. rate	7.1875
Treasury Bills 91-day, Middle Rates	12.55 discount basis	14.90	12.9375	15.00	n. a.	n. a.	19.102 85 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	14.00 finance paper discount basis	15.30 finance paper 15% tax w/h	12.19	13.90 Certified	16.75 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.75	15.25 15% tax w/h	12.9375	13.90 Certified	not traded	9.40	21.70	no market	4.4375	no market
Government Bonds Long-term, new and old issues, average yield	13.55	14.82	13.54	10.722 20% tax w/h	15.95	8.77	20.53	10.05	5.00	7.211
Industrial Bonds prime, long-term, new and old issues, average yield	14.85 Aa Industrials	15.50	14.93	15.038	17.02	8.72	20.46	11.10	6.00	6.61
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	17.00	14.00	17.50	18.50	13.00	21.75 ⅛ qtrly fee on outstdng.	11.00	9.50	6.00
Bank Time Deposits 3-month	14.00 Cert. of Dep.	14.75	13.50	14.75	16.50	9.00	11.50	8.75 large deposits	3.75 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	15.00	15.75	13.625	no market	23.25	8.875	no market	8.5625	4.25	7.00
Exchange Rates—in U.S.$ rates floating against the $	—	.8177	1.8040	.0229	.1654	.4321	.000779	.3884	.5156	.00427
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.734 *D*	1.619 *P*	1.278 *D*	7.990 *D*	6.411 *P*	9.794 *D*	6.596 *P*	11.036 *P*	8.190 *P*

Eurodollar Deposits
(London, interbank, bid)
May 6

7-day	15.4375
1-month	15.00
3-month	14.625
6-month	14.625

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.829
U.S.-Canada Treasury Bills	− .886
U.S.-Canada Finance Co. Paper	− .356
Eurodollars-U.K. Local Auth. Deposits	− .119

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	14.32
Over 7 yrs.	14.43
DM Bonds	
7 yrs. and under	8.875
Over 7 yrs.	9.125

Gold Price
London
afternoon fixing

338.40
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(March) 6.8	(March) 11.6	(March) 10.4	(March) 14.1	(April) 5.0	(April) 15.5	(March) 4.7	(March) 2.8
Industrial production*	(March) −7.2	(Feb.) −7.8	(Feb.) 0	(Feb.) −2.4	(Feb.) −2.7	(Feb.) −4.2	n. a.	(March) 2.8
Trade balance† *(billions of local currency units)*	(March) −$2.64	(Feb.) C$0.95	(Jan.) −£0.13	(March) −FF5.74	(March) DM6.42	(Feb.) −Lit.2.930	(March) −SF0.50	(March) ¥496
Money supply (M1)*	(March) 5.6	(Feb.) −1.7	(Feb.) 29.1	(Dec.) 14.9	(Feb.) 0.5	(Nov.) 7.4	(Dec.) −7.4	(Jan.) 6.8
Velocity of money (M1)*	(Dec.) 5.5	(Sept.) 15.7	(March'81) 4.5	(Sept.) −3.6**	(Dec.) 7.1	(Sept.) 4.00**	n. a.	(Sept.) −1.1
Reserves minus gold *($ million, change from previous month)*	(March) −120	(March) −521	(March) −325	(Feb.) 164	(March) 74	(March) −3.213	(March) 1.578	(March) −822

* Percent change from 12 months earlier

**based on GDP

† Figures are only for the month indicated

The Caribbean Basin: A Troubled Region

The U.S. Congress is currently conducting hearings on the Caribbean Basin Economic Recovery Act: a program proposed by the Reagan Administration to make available trade and investment incentives, and financial assistance to nearly two dozen countries in Central America, northern South America, and the Caribbean. The aim of the proposal is to help lay the groundwork for revitalizing this area, which over the past decade, has become a region beset with political and economic problems. To appreciate the importance of this objective, some perspective is needed—not only on how these countries differ, but also on the problems they share and on their prospects for the future.

The Caribbean Basin is a region of immense diversity. Many of the states in the Basin are not politically independent and have varying degrees of economic association with the United States, Canada, and European countries. Political systems range widely over the left-right spectrum, while economic systems run from free market to mixed economies. The region's population in 1980 totaled 43 million, excluding Cuba, and combined GDP for that year approximated $60 billion —equivalent to that of Venezuela. The populations of the individual nations range from as low as seven thousand for the Turks and Caicos Islands to over seven million in Guatemala. And per capita income levels vary from a high of $5,100 in the Bahamas to $280 in Haiti. Languages and cultures reflect centuries of English, Spanish, French, Dutch, indigenous Indian, African, and U.S. involvement. And the Basin nations differ markedly in physical size and resource endowments.

In spite of their differences, the Basin economies share several key chararcteristics. First, they each have markets relatively small in size, which denies them advantages of economies of scale. And because they are dispersed geographically, they suffer from high transportation and communication costs which limit opportunities for production based on traditional export items. Second, they are dependent in varying degrees on a few primary products or on a small number of manufactured goods, tourism earnings, and migrant remittances. As such, they are highly vulnerable to the vagaries of climatic conditions and international economic/political developments. Third, of all the Basin countries, only the nation of Trinidad and Tobago has a significant amount of hydrocarbons; the rest have had to absorb the sharp rise of energy costs in recent years. Fourth, over the past five years, expectations regarding economic prospects have been raised as a number of nations have gained independence and others are on the threshold of statehood. Finally, population growth rates remain high, for the most part. And because of the surge in population growth in the past two decades, the Basin population is very young, with the median age being approximately sixteen.

Recent developments and prospects

These characteristics have combined to make the past decade a very difficult one for the Caribbean Basin. Up until 1973, the area enjoyed fast growth owing to a healthy demand for its products, relatively stable import prices, growing tourist earnings, and substantial inflows of foreign investment in the mineral and tourism sectors. Since that time, many of these conditions have been reversed. The terms of trade have turned against the region, primarily because the unexpectedly large petroleum price hikes of 1973-74 and 1979-80 have not been matched by similar increases in the prices of its exports. Moreover, the economic slowdown in the industrial countries has negatively affected the area's volume of goods and services exports. The situation has been aggravated by sectoral development and exchange rate policies that have often been biased against agricultural development and export growth, and have fostered dependence on imported petroleum.

Thus, with the exception of a few economies, the Caribbean Basin countries are experiencing severe balance-of-payments difficulties, which, in turn, have necessitated implementation of unpopular and difficult stabilization programs. Unemployment and underemployment are pervasive, with the official unemployment rate averaging in the 20%-30% range for most of the economies. And, up until recently, inflation rates have been high, reflecting not only higher import costs but also price liberalization and the elimination of subsidies under the adjustment programs.

The inevitable consequence of the economic decline in a number of these countries has been a rise in political and social tension, particularly since the population is so young and economic expectations have been raised in the context of political independence. The Central American countries are in a different situation. With the exception of Costa Rica and Panama, they are experiencing socio-political upheavals that reflect years of discontent with fixed economic and political structures.

The prospects for the Caribbean Basin economies over the next five years are mixed: Some economies will come close to achieving their growth ambitions and others will have a difficult time. This will be true even under optimistic assumptions regarding exogenous events: namely, that the area's terms of trade improve, that economic activity in the industrial coun-

The Caribbean Basin: A Troubled Region

(continued from page 7)

tries picks up significantly, that multilateral and bilateral assistance increases, and that normal weather conditions prevail. In general, most of the more developed economies will probably grow at a pace that, although slower than in the 1960s, will nevertheless generate sufficient employment opportunities to maintain political stability. The less developed Basin economies, on the other hand, have been more critically affected by the economic decline of the past decade. Their physical infrastructure and human resources have been so depleted that—barring large aid inflows, technical assistance, and a return of skilled workers and managers—they probably will continue to experience economic hardships, which, in turn, will put greater pressure on the socio-political situation. Political tensions are also likely to intensify as a result of the changing demographic structure. Population growth in the 1980s should accelerate since emigration of the magnitude seen in the past decade is not expected to reoccur.

Outlook for major country groups

Central America. Prospects for the Central American countries are not encouraging. Until their internal political conflicts are resolved, expectations of renewed and sustained economic growth are unrealistic. Nicaragua's economic prospects are clouded by its apparent drift toward a collectivist economic ideology. The performance of the Guatemalan and Salvadoran economies has deteriorated with the spread of civil disorder. The economic outlook for Honduras would be relatively bright if it were not for its proximity to Guatemala and El Salvador. But events in those countries have greatly decreased investor confidence and triggered capital flight. Costa Rica and Panama—which are essentially free from political disturbances—are more developed economies with sufficient physical and human infrastructure to sustain steady growth. In the case of the former, however, this assumes that a serious economic adjustment program designed to correct the current internal and external disequilibrium will be adhered to.

The Caricom (Caribbean Common Market). Except for Barbados and Trinidad and Tobago, the Caricom[1] states—which comprise most of the less developed Basin countries—will face economic difficulty. The majority of the smaller countries have gained independence from Britain within recent years, and as such, have lost budgetary assistance at a time when massive oil price increases and a spate of natural disasters have occurred. The resulting financial difficulties have impeded development progress. Many of the countries have not been able to maintain the physical infrastructure badly needed for economic development—let alone expand it. Moreover, many skilled workers and managers have emigrated, depleting the area's human resource pool. Thus, realization of economic growth will be very difficult in the foreseeable future, and greater socio-political tension is likely. But civil disturbance of the magnitude seen in Central America is not expected to occur. The extreme income inequities and political rigidity that characterize Central America are absent, and labor unions—which play a leading political role and support a parliamentary system—as well as close family ties and the Church are important stabilizing elements.

The associated states. For those economies associated with European and North American countries[2] prospects are relatively good, chiefly because they will continue to benefit from preferential trade arrangements and financial assistance. Also, they are the more developed and diversified Caribbean economies with tourism, international banking, petroleum refining (the Netherlands Antilles), and light manufacturing determining a major portion of their livelihood. They possess satisfactory levels of physical infrastructure, a sufficient number of skilled personnel, and political stability.

Other independent countries. The outlook for the remaining independent Caribbean countries is mixed. The Bahamas should prosper based on tourism, international banking, and small assembly industries. A stable political climate and tax freedom will continue to make it a good base for international operations. The Dominican Republic will be constrained from achieving rapid economic expansion by the structural problems caused by fiscal, interest rate, exchange rate, and energy policies. Nevertheless, per capita income is likely to be maintained. Haiti's prospects are marred by extremely low domestic savings and investment rates. Finally, Surinam's outlook depends a good deal on developments in the bauxite sector and on aid flows from Holland that are currently jeopardized by a deteriorating political situation.

All things considered, the proposed Reagan assistance program, if approved, is likely to produce neither quick nor dramatic results over the near term. Nevertheless, combined with the complementary programs already put forth by Canada, Mexico, and Venezuela, it could help to establish a framework for economic revival in the Caribbean Basin over the long run.

Nina Ramondelli

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[1] *This includes Grenada, Antigua, St. Vincent and the Grenadines, Dominica, St. Lucia, Belize, Jamaica, Guyana, Barbados, and Trinidad and Tobago. Excluded from this discussion are Montserrat and St. Kitts-Nevis.*

[2] *These include the Netherland Antilles, the British and U.S. Virgin Islands, the Cayman Islands, the Turks and Caicos Islands, Puerto Rico, Guadeloupe, Martinque, and French Guiana. Monserrat and St. Kitts-Nevis, which are members of Caricom, are included in this category.*

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Interest Rates And the U.S. Recovery

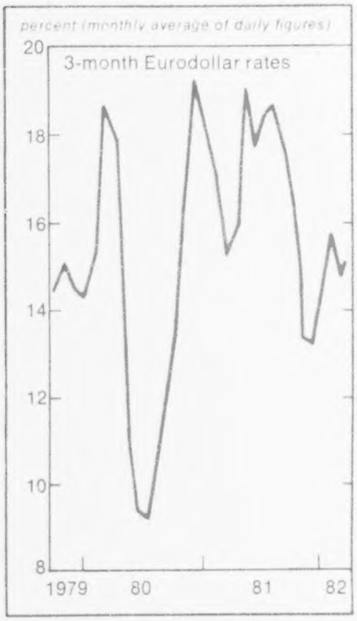
Now that the widely heralded April bulge in the U.S. money supply is past, the greatest source of uncertainty as to future short-term U.S. interest rates is the timing and magnitude of the economic upturn. Simplifying somewhat, two scenarios seem possible. In the first of these—and the one the market appears to judge most likely—the economy is now very close to its trough and is about to move into a period of slow recovery. In this instance, short-term interest rates should drift downward over the next two to four months before bottoming out; although, if the pace of recovery should prove to be stronger than is now anticipated, this downward movement would be reversed later this summer, with rates possibly retreating back to today's levels.

Two likely developments are key to this projection: First, the present battered state of corporate balance sheets argues for both a slow rate of inventory rebuilding and a decline in business credit demand in the initial phase of the recovery period. As the level of economic activity increases and cash flow improves, credit markets will be gradually relieved of the present credit demands by businesses to finance inventories and operating costs. Second, the demand for money is unlikely to be strong enough to work against falling short-term interest rates. Although the transactions demand for money will grow as the economy changes directions, the money balances that have been built up as a precaution against a further decline in the economy will begin to unwind.

A second recovery scenario is based on the assumption that the currently high level of real interest rates delays the U.S. economic revival by a quarter or more. Under these circumstances the corporate credit demands for inventory funding, operating costs, and refinancing a growing debt burden would increase in the near term, keeping upward pressure on rates. In addition, a further buildup in precautionary money balances could occur. Both credit and money-demand factors would thus work to keep short-term rates close to present levels for a period, but the stage would then be set for a dramatic rate decline.

When this break would occur would likely depend on events in Washington. The longer rates stay at current levels the greater the structural damage to the economy. If economic performance continues to slide over the next few months, the Federal Reserve and the U.S. fiscal authorities will have little choice but to act to relieve the pressures created by the management of existing policies.

Short-term interest-rate movements



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Tourism and increased public spending expected to fuel modest recovery in Spain this year.

Spain, like most European economies remains in recession. GDP in 1981 grew by only 0.3% despite an expansionary fiscal policy and a 7% volume growth in exports. Private consumption, undermined by ever rising unemployment and more moderate wage settlements was the major source of weakness, declining by 1.8%. This year promises a modest improvement and the government is optimistically forecasting 2.5% growth. The ending of the severe drought should bolster agricultural output substantially and further strong performances are expected from public consumption and public investment. Consumer demand, however, will remain weak. The World Cup soccer matches in June and July should ensure a strong tourist season. But, a sustained recovery will require a rise in Spanish exports to Europe. Currently, this is being hindered by weak demand throughout Europe and by the peseta's present strength against other European currencies. Nevertheless, Spain's current-account deficit, which remained at $5 billion in 1981, should decline toward $3.5 billion in 1982.

Reduced oil revenues force budget revisions on Norwegian government.

The Norwegian government is still adjusting its forecasts to take account of substantially reduced oil revenues. The revised budget for 1982, just presented to Parliament, projects that adverse developments in the oil and shipping sectors will more than offset a reasonably buoyant domestic economy, resulting in a 1.5% decline in GNP. Amended forecasts revised the balance of trade surplus down to kr 13.7 billion (from the kr 18.1 billion earlier). And, thanks to large interest payments on overseas debt, the current account is now expected to show a much smaller surplus of only kr 1.3 billion (against kr 3.7 billion in earlier projections). To counterbalance the larger shortfall in government tax receipts anticipated as a result of the lower oil revenues, the new budget proposes to increase non-oil taxes—a difficult move for the Conservative government which has been commited to using the country's oil revenues to direct resources away from the public sector towards the private. Nonetheless, the government claims some success for its policies to date. In addition, it still hopes that its 1983 budget—to be prepared this autumn—will show further cuts in government expenditures coupled with offsetting cuts in personal income taxes.

Icelandic recession may bring improvements in inflation, trade deficit.

Iceland's economic slowdown appears to be turning into a full blown recession. According to the April report of the National Economic Institute, per capita GNP is expected to decline by 2% in 1982 after growth of only 0.2% last year. Contributing to the downturn are weak world demand for aluminum and ferrosilicon exports and a poor capelin catch that has depressed Iceland's fishing industry. Nevertheless, the recession is expected to be relatively short-lived, coming to an end sometime in 1983 as the reviving world economy sparks increased demand for Icelandic exports. Furthermore, the recession is expected to generate some positive effects: It is anticipated the trade deficit on goods and services will fall toward 4.5% of GNP, down from 5% last year. In addition, some easing of labor market pressures may give the country a chance to moderate wage settlements and help bring the rate of inflation down below 50% for the first time in three years.

Venezuelan authorities opt for prudent policies despite upcoming presidential elections.

The reversal in the world petroleum market has come at a politically inopportune time for Venezuela, in that 1983 is a presidential election year. Nevertheless, in the interest of avoiding a return to large fiscal deficits and balance-of-payments disequilibrium, the Herrera administration has apparently opted against stimulative economic measures in favor of a more cautious policy approach. According to official projections, this year's central government budget revenues will be some 13-14 billion bolivars ($3-3.3 billion) less than previously projected in light of the sharply lower oil export earnings. To cover the gap, the authorities are relying principally on a 10% reduction of current spending by all public entities, which, if successful, could reduce central government expenditures by some 8 billion bolivars ($1.9 billion). The remainder is to be financed by substantial gasoline price and airport exit tax increases, elimination of customs exemptions for state companies, and utilization of uncommitted Treasury reserves.

China may have achieved trade surplus last year.

In late April, the State Statistical Bureau in Beijing announced that China had achieved virtual trade balance in its foreign trade during 1981. Total exports increased 18% in real terms to approximately $21.6 billion (f.o.b. basis), while total imports rose 5% in real terms to a similar dollar level (c.i.f. basis). However, given the current reorganization of the foreign trade bureaucracy and the authority that has been decentralized for the most dynamic coastal provinces, the true status of China's foreign trade in 1981 remains uncertain. Western trade partner data suggest that China actually achieved a significant trade surplus last year. In its March-April issue, JETRO's *China Newsletter* published its preliminary estimate of a $2.44 billion trade surplus for 1981, with Chinese exports worth $22.4 billion. China's most buoyant export market in 1981 was the United States where sales rose nearly 80% to $1.9 billion, while U.S. exports to China actually fell 4% to $3.6 billion. China's official figures would imply that fourth-quarter imports approached the record level of $6.5 billion set in fourth-quarter 1980. Since already available OECD data fail to indicate a sizeable increase, such a surge could only have come from Hong Kong or elsewhere in Southeast Asia.

Korean current-account gap not likely to exceed target, despite markedly slower export growth.

The continued weakness of the world economy is having a serious impact on Korean export growth. In the first four months of this year, the annual rate of export growth slowed to 5.3% compared with a rate of 21% last year and an even higher rate throughout the 1970s. The government now faces a choice: It can either wait out the global recession and risk the potential political embarrassment that would result from a failure to meet its 1982 export target of $24.7 billion; or, it can adopt some sort of export stimulus measures—probably a further lowering of interest rates and a devaluation of the won—which may or may not prove to be effective. However, even in the event that exports do fall below target, there is little likelihood the current-account deficit will increase beyond the level planned, as the government is reluctant to increase external financing at currently high interest rates. Possible adjustments could come from the import side—either from slower economic growth or from specific policy measures designed to stem import growth.

Burmese economic boom accompanied by heavier debt burden.

After a long period of stagnation and decline, Burma has enjoyed a modest economic boom over the past several years, thanks to a "green revolution" in agriculture and large amounts of concessional aid. Real growth is estimated to have been 6%-6.5% for the fiscal year just ended in March, and over the past five years growth has averaged 6.4%. The country's improved economic performance has been accompanied, however, by a growing debt burden—the debt-service ratio, defined to include service receipts, now exceeds 20%. If the recent pace of growth is to be maintained, the Burmese government will have to take steps to boost its exports and to turn increasingly to sources other than loans—namely, domestic savings and foreign direct investment—to finance its development projects.

Foreign financing critical to Yemeni development plan.

The Yemen Arab Republic has recently launched its second five year development plan covering 1982-86. The ambitious program calls for a 7% annual growth rate to be generated by 29.3 billion riyal ($6.4 billion) of investment aimed at developing the country's currently meager domestic productive base. By increasing production of basic manufactures and agricultural commodities, the authorities hope to hold import growth to a mere 1% per annum in order to prevent the current-account deficit from deteriorating in real terms. Foreign financing totaling $3.4 billion will be required over the plan period, of which only $330 million is expected to be in the form of direct investment, mainly from Yemen's Arab allies. The balance, some $600 million a year must come from loans, although there are doubts as to whether amounts of this size will be available in the form of concessionary funding. If the plan is successfully implemented, however, the Yemeni population can expect to move another step away from their extreme poverty. Nevertheless, prospects for sustained economic prosperity over the longer run will depend on the success of current oil exploration efforts.

Distress Borrowing Cannot Last

The surge in short-term corporate borrowing so far this year has exceeded most observers' expectations. The levels of commercial and industrial bank loans and non-financial commercial paper outstanding have grown at an annual rate of nearly 23% since January. By normal standards this growth is unusual, given the weakness in the economy, the sizable inventory liquidations that have occurred, and the depressed state of corporate investment spending plans.

The special characteristic of this recession that accounts for the significant increase in credit demand is the highly leveraged nature of corporate balance sheets. Debt-to-total-asset ratios on a book value basis have risen from an average of less than one-third in the early 1970s to over one-half today. Much of this rise has come in the short maturities (less than one year), as firms have been reluctant to commit themselves to long-term debt obligations at existing high interest rates. These circumstances require them to refinance periodically at historically high interest rates, swelling the magnitude of their interest payments.

As profits and cash flow have deteriorated because of sagging consumer spending, these firms have found themselves in financial distress, needing to borrow an increasingly greater amount to finance their heavy interest commitments in order to avoid bankruptcy. Nevertheless, the extent to which the large volume of short-term borrowing in the first half of 1982 has been distress-related suggests that this trend cannot sustain itself indefinitely—whether or not the expected economic recovery materializes in the second half of the year. If the recovery does progress on schedule, cash flow will improve. This will enable firms to meet their interest obligations out of internally generated funds and perhaps retire some of their outstanding debt and rebuild liquidity. If, on the other hand, economic activity does not rebound, more over-leveraged firms will go bankrupt. By eliminating some of the heaviest borrowers, this development would also serve to slacken the pace of corporate credit demand—at least in the short run. Thus, regardless of the state of the economy, the demand for bank loans and commercial-paper borrowings should slow later in the year.

Another development that would reduce short-term credit demands, of course, would be a decline in long-term interest rates large enough to allow some funding out of the heavy short-term debt burden. As lower inflation figures are reported each month, this eventuality becomes more and more likely. Although it would not necessarily alter the total level of outstanding debt, it would serve to lengthen the maturity structure of this debt. This would mitigate the hectic refinancing activity that has been accelerating corporate credit demands.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1980		BALANCE O				
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use o credit lions of
Austria	Economic growth of up to 2% expected this year—stronger than for rest of Europe.	Jan.	+7%	76.5	+3.1%	March	4,873	−9%	2.8	
Belgium	Inflation rise likely after Feb. devaluation, but small increase in real GNP expected for 1982.	Jan.	+4%	96.1*	+2.0%	March	3,985	−35%	0.8	
Britain	Economic upturn expected this year, although few signs of it have emerged so far.	March	0	523.5	−1.7%	March	14,430	−31%	1.6	27
Denmark	Growth prospects good but government plans to increase taxes from July 1st.	Feb.	−1%	64.7	−0.2%	March	2,102	−31%	1.4	
Finland	Pace of economic activity is beginning to slow.	Jan.	+2%	47.8*	+1.0%*	March	1,552	−13%	1.3	4
France	Recovery losing steam as surveys detect less business confidence regarding outlook.	Feb.	−2%	657.0	+1.6%	Feb.	20,560	−31%	2.0	
Germany	Industrial order volume still declining; economic institutes revise 1982 growth forecast down to 0.5%.	March	0	689.4*	−0.3%*	March	41,174	−18%	3.0	
Greece	Real investment likely to fall sharply for third year in a row despite expected small upturn in GNP.	Dec.	−2%	41.8	+1.6%	Jan.	633	−41%	0.8	
Ireland	Feb. industrial production showed sharp upturn to 7.9% above level of year earlier.	Dec.	+9%	17.6	+1.9%	March	2,394	−5%	2.7	
Italy	Economy recovered somewhat at year-end 1981, but leading indicators fail to indicate sustained upturn.	March	−2%	394.9	+4.0%	March	14,765	−18%	1.9	
Netherlands	Coalition splits on issue of spending cuts; minority government or new elections possible.	March	−2%	167.4	+1.0%	March	9,287	−15%	1.7	
Norway	Falling oil production and weak shipping sector will result in GNP fall of some 1.5%.	Feb.	+2%	55.4	+3.6%	March	6,065	+15%	4.4	
Portugal	Upward price pressures growing; year-on-year inflation rate was 27.1% in March.	Oct.	+1%	23.5	+5.5%	Feb.	382	−31%	0.5	4
Spain	Expansionary budget and end of drought should ensure modest growth in 1982.	Nov.	−1%	211.1†	+1.2%	Feb.	10,140	−10%	3.9	1
Sweden	April's revised national budget predicts a 1.4% rise in GDP this year.	Feb.	0	122.9	+1.4%	March	3,412	−18%	1.4	
Switzerland	Marked weakness in foreign orders confirms overall picture of economic slowdown.	Dec.	+3%**	97.8*	+3.9%	March	12,512	−3%	4.7	
Canada	Unemployment rate reaches a record 9.6% in April as industrial production declines.	Feb.	−8%	274*	+3.0%*	April	2,717	+20%	0.4	
United States	Recession shows signs of lingering as interest rates have remained high.	April	−7%	2,925.5*	+2.0%*	March	18,800	−2%	0.9	

*1981 **4th quarter average over 4th quarter average †GDP

Grappling With the Budget

As Congress and the president attempt to zero in on a compromise on the federal budget, they appear to be caught between economic reality and election-year politics. A steeper-than-expected recession has worsened the outlook since President Reagan introduced his budget proposals in February. Thus, the administration has been forced to increase the size of proposed "deficit-reducing measures" to hold the fiscal 1983 deficit near the $100-billion level. The unpleasant truth that the budget writers face is that any action to reduce the deficits carries with it the potential for reducing some constituents' spendable incomes. Thus, any stimulative effects that might derive from a smaller deficit—chiefly, it is hoped, through lower interest rates—may well be offset by reductions in purchasing power.

As recently as two months ago, there were assertions that the administration was overstating the fiscal 1982 deficit in an effort to draw out the more frugal instincts of House and Senate budget committee members. The basis for these claims was that, while projections had placed the deficit at around $100 billion, the cumulative deficit through February was actually running some $2 billion behind the deficit for the comparable period in fiscal 1981, when the deficit for the year had totaled only $58 billion. This "deficit shortfall" proved to be temporary, however. The rapid growth in tax receipts that had helped bring it about—spurred by a hike in the interest rate charged on late tax payments to 20% from 12%—has slowed markedly. By March the deficit was about $9 billion above the year-earlier level. Prospects of similar wide gaps in April and May have renewed expectations of a $100-billion deficit for fiscal 1982.

In the current negotiations on the fiscal 1983 budget, the "baseline" deficit that would occur without any further congressional action is estimated at $182 billion. To bring the deficit down to the $100-billion level would require about $80 billion of either revenue increases or spending cuts. The budget writers thus far have agreed to modest cuts in nondefense, non-entitlement spending, and to a $5-billion scaling back of the increase in the defense budget approved last year. Some saving is also expected from lower financing costs that would result from a smaller deficit. In addition, congressional budget committee members are counting on highly uncertain proposed presidential actions that would bring an additional $20 billion into the federal coffers from such measures as increased user fees and sales of government assets. And there appears to be a consensus that taxes will have to be raised by some $25-30 billion.

The particulars of both the spending cuts and the tax increases, however, will be difficult to achieve, given the pressures of different constituencies. The longer the budget outlook remains clouded, the more likely it is that the credit markets will continue to demand an interest premium for this uncertainty—which could delay the recovery and up the likely size of the deficit.

F PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes							
IMF mil- dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	central bank rate△	exchange rate in U.S. dollars May 19, 1982	current monetary conditions	
0	Export orders strong, current account in surplus during first quarter of 1982.	March	+6%	Feb.	+3%	6.75%	.0612	Interest rates follow German rates.	**Austria**
0	Loosening of wage indexation will increase export competitiveness.	March	+8%	Dec.	+2%	14.00%	.0228	Belgium franc continues to suffer from speculative attacks.	**Belgium**
8	Latest figures show current-account surplus of $10 billion at annual rate.	March	+11%	Feb.	+16%	13.06%	1.7870	Rates down slightly despite Falkland Islands uncertainty.	**Britain**
0	Current-account deficit of kr. 13 billion expected for 1982.	Feb.	+12%	Dec.	+12%	11.00%	.1269	Interest rates kept high by devaluation rumors.	**Denmark**
5	Current-account surplus was fmk 1.2 bn. in first quarter, vs. 95 mn. year ago.	March	+10%	Nov.	+17%	9.25%	.2207	After some easing, central bank raised reserve requirements.	**Finland**
0	Current-account deficit of around ff 50 billion expected in 1982.	April	+14%	Dec.	+16%	9.50%	.1650	Expected EMS adjustment keeps interest rates high.	**France**
0	Current-account surplus now widely forecast for 1982.	April	+5%	Jan.	+1%	7.50%	.4306	Bundesbank abolishes Special Lombard Rate.	**Germany**
7	Current account in 1981 failed to improve despite small decline in real GNP.	Feb.	+20%	Nov.	+24%	20.50%	.0162	Monetary policy being eased.	**Greece**
0	First quarter current-account deficit 548 million pounds.	Feb.	+19%	Feb.	+6%	18.50%	1.4950	Interest rates remain at 20%; budget deficit persists.	**Ireland**
0	First quarter trade deficit rose to lit. 5.5 trillion, from lit. 4.9 trillion year earlier.	April	+16%	Nov.	+7%	19.00%	.000776	Money continues tight.	**Italy**
0	Current account remains in healthy surplus.	April	+7%	Jan.	+1%	8.00%	.3880	Government crisis leads to higher interest rates.	**Netherlands**
0	Healthy trade surplus of kr. 13.7 billion expected in 1982.	March	+12%	Dec.	+15%	9.00%	.1670	Credit policies remain restrictive.	**Norway**
0	Exports weak, but drought end should reduce food and electricity imports.	Jan.	+24%	Nov.	+14%	18.00%	.0140	Interest rates raised in attempt to curb credit demand.	**Portugal**
4	Current-account deficit forecast to fall to $3.5 bn. in 1982, vs. 1981's $5 bn.	Feb.	+15%	Dec.	+13%	8.00%	.00969	M3 growth target of 16% implies slight policy easing.	**Spain**
0	Debt service will keep current account deficit near kr. 14 bn. vs. 81's kr. 16 bn.	March	+9%	n. a.	n. a.	10.00%	.1718	Despite slight easing monetary conditions remain tight.	**Sweden**
0	Loss of export competitiveness may further curtail current-account strength.	April	+6%	Jan.	+11%	5.50%	.5053	Rates down sharply as central bank boosts liquidity.	**Switzerland**
0	Falling import demand produces trade surplus.	March	+12%	April	+2%	15.41%	.8086	Interest rates stay at high levels.	**Canada**
0	Continuing global slowdown affecting U.S. export growth.	March	+7%	April	+5%	12.00%	—	Business borrowing robust as economy remains weak.	**United States**

△ most recently reported

World Interest Rates

market rates as of May 19, 1982; bond yields as of May 14, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	15.41	13.06 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.00	5.50	5.50
Day-to-Day Money	14.375 May 20	15.25	13.50	13.00	16.375	9.50	20.50	8.875	3.25 1-month Euro-Swiss fr. rate	7.1875
Treasury Bills 91-day, Middle Rates	11.86 discount basis	15.25	12.813	15.00	n. a.	n. a.	19.05 87 days	no dealing	no market	5.625 two months
Commercial Paper prime, 3-month, asked	13.50 finance paper discount basis	15.55 finance paper 15% tax w/h	12.184	13.90 Certified	16.313 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.75	15.65 15% tax w/h	12.813	13.90 Certified	not traded	9.40	21.80	no market	3.938	no market
Government Bonds Long-term, new and old issues, average yield	13.31	14.70	13.24	10.722 20% tax w/h	15.55	8.77	20.81	10.05	4.86	7.13
Industrial Bonds prime, long-term, new and old issues, average yield	14.60 Aa Industrials	16.70	14.50	14.324	16.83	8.80	20.69	11.04	5.95	6.63
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	17.00	14.00	17.00	18.50	12.50	21.75 ¼% facility fee on outstanding	10.50	9.50	6.00
Bank Time Deposits 3-month	14.875 Cert. of Dep.	15.60	13.563	14.60	16.313	8.90	11.50	9.00 large deposits	2.50 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	14.8125	15.875	13.625	no market	27.50	8.813	no market	8.938	3.813	7.125
Exchange Rates—in U.S.$ rates floating against the $	—	.8086	1.7870	.0228	.1650	.4306	.000776	.3880	.5053	.00418
Forward Exchange Cover 3 month, in percent p.a. *D* = discount, *P* = premium	—	1.039 *D*	1.509 *P*	1.680 *D*	10.863 *D*	6.020 *P*	9.254 *D*	5.767 *P*	11.072 *P*	7.800 *P*

Eurodollar Deposits

(London, interbank, bid)
May 20

7-day	15.00
1-month	14.875
3-month	14.625
6-month	14.625

International Arbitrage

(3-month, hedged) + in favor of U.S. dollars

U.S.-U.K. Treasury Bills	−2.285
U.S.-Canada Treasury Bills	−1.591
U.S.-Canada Finance Co. Paper	− .798
Eurodollars-U.K. Local Auth. Deposits	+ .0535

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	14.125
Over 7 yrs.	14.375
DM Bonds	
7 yrs. and under	8.375
Over 7 yrs.	8.6875

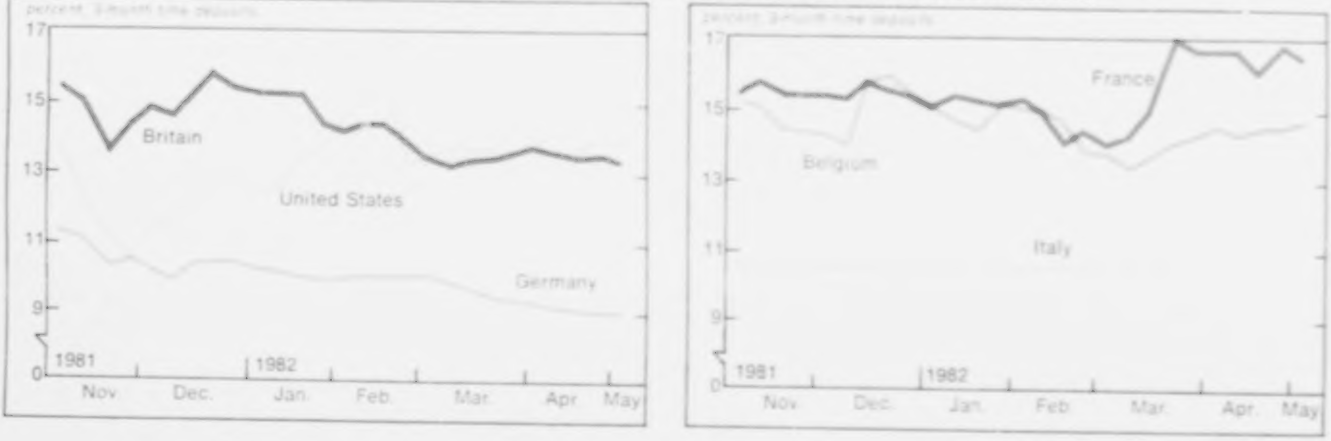
Gold Price

London
afternoon fixing

342.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Interest-rate movements in selected industrial countries



Some Fallout From the World Recession

The worldwide recovery is on its way but in no hurry to get here. The few signs of an upturn that are beginning to emerge suggest a revival that is likely to be painfully slow. Consensus world economic growth projections for 1982 have been reduced significantly from earlier forecasts, and there is substantial likelihood that even this revised outlook is overly optimistic. The extensiveness of the global decline in output over the past year and the uncertainty generated by volatile interest rates and foreign exchange markets have continued to test government policies and strain the viability of international institutions. It is quite possible that problems have been created that may not disappear immediately with the recession's end.

A sluggish recovery will undoubtedly compound pressures for more expansionary, monetary and fiscal policies and increased protectionist measures. Already, Germany has been called upon to act as a "locomotive" and pull its European neighbors out of the recession. And the United States repeatedly has been chastised by many of its trading partners for everything from high interest rates to poor fiscal management. Within the current institutional framework, however, there are limits to what policymakers can do without abandoning their stated longer-term goal of achieving sustained recovery without inflation.

Policy constraints and the recession

One of the primary causes of the recession—and a principal obstacle to a more robust recovery—has been the behavior of U.S. monetary aggregates and interest rates. Unprecedented volatility in money growth and interest rates, ignited by the Federal Reserve's change in operating strategy in October 1979, touched off the recession in the United States. The downturn has been transmitted to other economies via integrated international financial and goods markets. The worldwide slump has been perpetuated by the persistently high level of U.S. real interest rates, as monetary authorities in other countries have refrained from enacting more stimulative monetary policies for fear of encouraging an outflow of reserves and/or a depreciation of their currencies. Members of the European community have found this situation particularly troublesome, given the confines of the EMS.

In general, a group of countries wishing to maintain a system of fixed exchange rates must implicitly accept a common monetary policy. For example, if one country pegs its currency to another but is printing money twice as fast, its monetary reserves will flow out through either a deficit on the trade account, a deficit on the capital account, or both. Eventually, the country running the more expansionary monetary policy will be left without reserves and will have to devalue. At the same time, as prices are being arbitraged, the more expansionary monetary policy results in the higher inflation then consistent with devaluation.

In the case of the EMS, Germany cast its lot with the United States in the fight against inflation—partly because of the importance German policymakers placed on maintaining the value of the mark relative to the dollar. France, on the other hand—along with Belgium and Italy—has tended to move toward a more expansionary, higher-inflation path. As a result, in order to maintain its low-inflation policy, Germany must continue to tolerate a weakening French franc—largely negating the usefulness of the EMS as it is presently structured.

The short-run volatility of U.S. interest rates—attributable to the current operating tactics of the Fed—has made the German position vis-a-vis the French even less tenable within the EMS framework. The French government's intransigence with respect to its expansionary policies placed Germany in the position of either choosing higher inflation or accepting U.S. policy decisions. By opting for the latter, the Germans accepted a certain amount of U.S. financial market volatility as well as higher unemployment over the near term.

The same fate has befallen other countries that have chosen not to ignore the value of the dollar. Exchange rates have not been as flexible as might have been expected, given all the stated differences in individual country policies. The policies actually followed by most countries have been reasonably consistent with those of the United States, and with them have come some of the problems as well as the benefits deriving from Fed policy.

Even the Japanese have not been immune to recent policy shocks. Much to the surprise of many forecasters, the yen has remained weak in spite of Japan's strong current account. With the liberalization of its capital-market controls, Japan is now exposed to the same set of international money-market constraints that other industrial nations face.

Unemployment and policy pressures

The pervasive problems brought on by U.S. monetary policies have compounded the strains of the slowdown in world trade that stemmed from the oil price shocks of the late 1970s and the decline in U.S. economic activity. As a result, unemployment in the industrialized nations has risen close to the post-war high, eliciting stepped-up demands for protectionist measures. To erect greater barriers to trade, of course, would merely extend the life of the recession and

Some Fallout From the World Recession

(continued from page 7)

diminish the potential for recovery once it begins. Moreover, policymakers would do well to remember that such protectionist activities were partly responsible for turning the 1929 recession into the Great Depression. Nevertheless, the pressures in support of such economic provincialism are likely to continue as long as growth is lackluster and unemployment remains high. The trade reciprocity issues currently under discussion must be carefully addressed, in that there is a danger that reciprocity could become "protectionism in the name of free trade." To avoid giving in to protectionist sentiments, the policymakers of the major trading nations must be mindful of already existing non-tariff barriers to trade.

Along with the increased protectionist demands have come demands that the United States should change its policies and bear the brunt of the recession it brought about. To be sure, while some displacement of production has been inevitable with the disinflation process, the persistence of high and volatile interest rates—contributing to the prolonged recession in the United States—is primarily the responsibility of the Federal Reserve. However, there are, at present, limits to what the Fed can do about this.

Given the low level of credibility inherited by the Fed from the pro-inflation policies of the 1960s and 1970s, the flexibility of the central bank within its current operating strategy is severely constrained. A move to bring down U.S. interest rates by abandoning the targets set for the growth of the monetary aggregates would be a signal to the market that the recent gains in reducing inflation are likely to be temporary, lasting only until the recession is over. With its skepticism about Fed policy then confirmed, the market would act to push interest rates even higher, which could lead to significant weakening of the dollar and a worldwide rekindling of the inflationary environment of the 1970s. All in all, the Fed has painted itself into a corner from which it cannot easily retreat. It must adhere to its aggregates-targeting policies, but at the same time it must find some way of improving its short-run operating procedures in order to minimize the inevitable strains of a sluggish recovery.

Coping with volatility

Despite the disquieting results of short-run policy actions and the disappointing prospects for economic activity in the near term, there are a number of encouraging signs for the longer run. For one thing worldwide markets are learning how to cope with erratic monetary policy and volatile interest rates. With the increased use of new risk-sharing instruments, such as financial futures and options, corporations are learning to live with interest-rate volatility in the 1980s just as they learned to live with exchange-rate volatility during the 1970s. As the markets for these new instruments become more mature, they will effectively become the private sector's insurance against public-sector policy shocks. Another promising sign is that some progress is being made in bringing government spending under control. However, the battle is far from won in the United States, or in Germany and the rest of Europe. Finally, and, perhaps most important, the disinflation process is under way and moving faster than anyone had thought possible.

All of these advances will translate into lower inflation expectations and lower interest rates over the next year. If additional progress is made in reducing U.S. federal spending and if the Federal Reserve can get its short-run aggregates policy under control, the elements will be in place for a strong, low-inflation recovery in the United States. The stage would then be set for a recovery without inflation abroad. A concerted effort by the industrialized nations to solve, once and for all, the key problems of inflation expectations would go a long way toward reordering the structure of world production to achieve higher per-capita output. And this, in turn, would lead to a greater real rate of return on savings and investment worldwide, not to mention a more stable commodities market.

The crucial question over the next several months will be whether the policymakers of the western economies will be able to resist pressures for nationalistically motivated action—action that could preclude a sustained worldwide expansion in 1983 and beyond.

D. Sykes Wilford

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Has Germany Really Achieved Policy Independence?

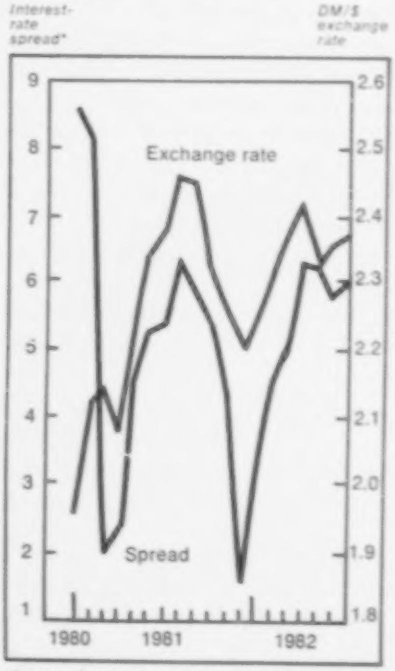
Against the background of a policy of monetary ease that was initiated last fall, a new attitude has recently emerged in Germany. After acting to reduce domestic interest rates on four separate occasions, German monetary authorities have announced that Germany has gained a "measure of independence, . . . uncoupling, to a very great extent" interest rates in Germany from those in the United States. In light of the European criticism of high U.S. interest rates voiced at the economic summit in Versailles, this new attitude of German independence is truly enigmatic. Has Germany, indeed, succeeded in reducing domestic interest rates without undermining the mark against the dollar? Or, alternatively, are the Germans merely attempting to provide assurance to the market, anticipating potential criticism of their stimulative policies?

The German authorities began relaxing their stance on monetary policy last October, after the dollar had weakened from its summer high. During the following five months, as official interest rates in Germany were lowered further and spreads favoring the dollar widened, the mark weakened—at times, substantially. For example, during the first quarter of 1982, the mark, at one point, had depreciated almost 10% against the dollar, relative to its position when the German easing began. From this perspective, it is difficult to perceive the German independence. It becomes even more difficult in light of the fact that U.S. interest rates, on average, have not risen since the German reflationary policy began. In fact, the widening of Eurocurrency spreads, favoring the dollar, reflects the expansionary German policy.

As long as financial capital is freely mobile, the economics of international capital markets precludes independence of a country's domestic interest-rate policy. However, to say that monetary policies are not independent is *not* to say that exchange rates always follow interest-rate differentials. A major shift in market sentiment regarding relative inflation differentials can cause a realignment of exchange rates in relation to relative market interest-rate spreads. As an example, while interest differentials favoring the dollar have shrunk significantly since 1980, the dollar has appreciated over 20% against the mark. The key seems to be a greater improvement in U.S. inflation compared with Germany's.

Taking all of this into account, the statements of German independence are merely attempts to assure the market that the recent expansionary monetary policy will not further confirm the assessment of a weaker mark relative to the dollar over the long run.

Relative interest rates and the value of the dollar



*3-month Euro $ rate minus 3-month Euro DM rates

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French recovery fading; current-account and budget deficits widening.

France's latest economic data have brought only bad news to the French authorities. Despite attempts to reflate the economy, the recovery appears to be running out of steam. Investment remains severely depressed and foreign demand shows no sign of picking up. It now seems unlikely that the government can achieve its target of 3% real GDP growth this year. Moreover, inflation remains around 14% and the current-account deficit continues to widen. The April trade gap of FF 10.1 billion was the largest deficit for a single month since 1968. The cumulative deficit for the first four months amounts to FF 26 billion compared with FF 14 billion in the corresponding period of last year. In addition, the projected deficits of the central government's own finances and of the Social Security Fund are causing disquiet. There are some grounds for believing that these problems will now lead the authorities to tone down their expansionary aims. In the more immediate future, a downward adjustment of franc intervention limits within the European Monetary System remains in the cards. Speculation on this remains intense as reflected by the high level of Eurofranc interest rates.

Denmark set for recovery; devaluation pressures unlikely to subside.

The Danish economy appears set for recovery, with real growth of at least 2% expected this year. Faster growth will boost government revenues and this year's budget deficit is projected to be some Dkr 51 billion—just under 11% of GDP instead of the 16% figure that had been widely forecast. Inflation, however, remains high, with consumer prices up 11.3% in the year to March and wholesale prices up 10.7% in the year to April. This has led to continuing fears of another kroner devaluation. These fears have some basis, in that with wages set to rise about 12% this year, Danish export competitiveness will come under increasing pressure as the year progresses. In addition, it has not been forgotten that Denmark asked for a 7% devaluation in February but had to agree to only 3%. This would seem to suggest that the remaining 4% drop will not be long coming. However, the government has indicated that it wishes to hold to today's exchange rate at least until the summer is over.

Swedish economy beset with problems; further policy changes needed.

The Swedish economy is improving but still has a long way to go. The government has made a number of policy changes aimed at correcting the country's economic problems, including: a cut in the growth of public spending, tax reforms designed to stimulate work incentives, measures to boost saving, moderation of wage increases, and a reduction in subsidies to industries. Unfortunately, however, these policies have not yet had their full effect. Industrial production has remained weak, investment has fallen, the budget deficit has continued to rise, and the current-account deficit has not improved. GDP is expected to grow by only a little over 1% this year. Some progress is likely in reducing the rate of inflation. Consumer prices are expected to increase less than 9% on average—the first single digit inflation rate since 1979. Nevertheless, it appears likely that further policy changes in the direction of those already enacted will still be needed.

Ecuador devalues sucre in an effort to improve trade balance.

Bowing to the pressure of a sharp decline in international reserves, Ecuadorean officials devalued the sucre on May 13—down to 33 per U.S. dollar from its previous level of 25. This was the first official devaluation since 1970, although a multiple exchange rate system had been set up in March in an attempt to stave off a full devaluation. But lagging oil exports and high import demand left the authorities with little choice. Last month's action requires all imports, exports, and new loans to be transacted at the new rate. If holders of existing private-sector foreign debt agree to refinance, however, they may obtain dollars at a more favorable rate. Beyond these official rates, a parallel free market—fluctuating at around 43-46 sucres—exists for tourist and other transactions. The Ecuadorean government is currently preparing a stabilization plan to support the devaluation And although authorities expect some initial slowdown in economic growth as a result of the move, they also hope to see an improvement in foreign trade from the parity change.

Improvement in government finances key to Peruvian adjustment program.

Peru is pursuing an economic stabilization program for which it hopes to obtain the financial backing of the International Monetary Fund. In March, the authorities reached an agreement on a three-year Extended Fund Facility arrangement for SDR 650 million, subject to IMF Board approval in June. The objectives of the program are to restore balance-of-payments equilibrium, lower inflation, and boost economic growth rates. Critical to the adjustment effort is a significant improvement of government financial operations. Peruvian officials hope to reduce the public-sector deficit to the equivalent of 4.2% of GDP this year from 7.8% in 1981. Whether this goal will be realized, however, depends on the government's willingness to take several potentially controversial policy steps, including: the elimination of most of the remaining subsidies for basic foods, frequent upward adjustments of petroleum prices and public-utility tariffs, the introduction of some additional tax measures, and, most important, a large reduction of expenditures, particularly investment outlays.

Higher interest rates bring surge of capital into Australia.

Australia's external capital inflows, which had slowed down substantially as last year's resources boom subsided, are now reviving in response to a sharp increase in interest rates. Rates on 3-6-month certificates of deposit, for example, have risen more than 500 basis points since the beginning of the year. Tight monetary control, instituted by the government out of concern for inflation and wage pressures, was the principal cause of the rate hike. Since world market rates have generally declined during this period, international interest-rate differentials have turned increasingly in Australia's favor. As a result, capital inflows have surged, reaching a record level of A$2 billion in April. For the moment, the renewed inflow of capital relieves the government from immediately having to decide on some sort of trade or exchange rate policy changes to stem a widening current-account deficit. However, the benefits on the real economy from these interest-rate sensitive financial flows will be markedly smaller than last year's resource-induced investment funds.

Continued recession forces Philippine government to rein in budget.

The Philippine government is under pressure to take steps to contain its 1982 budget deficit in light of the continued slump in both domestic and international economic activity. Last year, despite expenditure cuts, the budget deficit rose to an estimated 11.9 billion pesos, or 3.9% of GNP—some P2.8 billion higher than officials had forecast. This was a substantial increase over 1980's P3.4 billion deficit which equaled only 1.3% of GNP. The primary reason for this poorer-than-expected performance was a shortfall in revenue resulting from the depressed state of the economy. In 1982, the deficit is projected to narrow to P10.5 billion or some 3% of GNP, but the danger of another revenue shortfall and a significantly wider budget gap still exists. As a result, the government recently announced plans to cut expenditures by P5 billion or almost 10%. Whether this action will be sufficient is not clear. However, it is certainly a step in the right direction to help contain both the budget and balance-of-payments deficits in the face of the adverse external circumstances.

Ivory Coast economy stagnant; sights lowered for oil output.

Continued restrictive fiscal and monetary policy and an outflow of capital induced by unfavorable interest-rate differentials have brought economic stagnation to the Ivory Coast. Real GDP growth slowed to 1.4% in 1981 and no growth is foreseen this year. External accounts showed some improvement over the record deficits of 1980 as dampened aggregate demand led to lower imports. Still, the 1981 current-account deficit is estimated to have been close to $1.5 billion and a similar shortfall is projected for 1982. Consequently, further substantial borrowings will be required on top of an outstanding foreign debt that is already over $5 billion. Debt-service obligations are expected to claim some 35% of foreign exchange earnings this year. In addition, previous forecasts of expansive petroleum exports by the mid-1980s have had to be substantially revised. Oil self-sufficiency is still projected for 1983, but exports are now expected to be modest, at least over the medium term.

Fed Policy: The Old Versus the New

The recent declines in money market rates, in response to the slowdown in money growth since mid April, once again illustrate the importance of the behavior of money in determining the course of money market rates in the short run. This relationship has been observed since the early 1970s, when the Federal Reserve switched to a policy strategy of targeting monetary aggregates. But it has become more pronounced since October 1979, when the Fed shifted the focus of its operating tactics from the federal funds rate to bank reserves. It is somewhat surprising, however, that, on average, the timing of the reaction of the funds rate to deviations of money growth from target since the Fed's tactical change has been quite similar to that of the earlier period, with one notable exception. What is disconcertingly different between the two periods is that it is now much more difficult to discern not only when the short-run policy stance of the Fed has changed, but also, the implications of any such change for the behavior of the funds rate.

Prior to October 1979, the operating target of Fed policy was a narrow trading range for the federal funds rate, and open-market operations were designed to keep the funds rate within this range. Whenever money growth deviated from target, the Fed attempted to bring it back into line by adjusting its funds-rate target. Disillusion with the ability of the Fed to control money growth via this tack was at least one—although by no means the only—force leading to the October 1979 shift to using bank reserves as the principal target variable.

While the Fed's current approach to monetary control through managing bank reserves is allegedly "supply-oriented," in reality, the effect of policy action on the federal funds market is still a major link to money growth. The reason for this is that under the new operating tactics, the Fed controls not total reserves, but "non-borrowed" reserves, that is, total reserves less reserves supplied through discount-window lending. This is mainly because the Fed's lagged-reserve accounting system means that required reserves are determined each week by the level of reservable deposits held two weeks earlier. Under the new tactics, if money growth is greater than desired, banks' demand for reserves rises as a result of the increase in reserves required to support the higher level of deposit growth. If the non-borrowed reserve target remains unchanged, then the funds rate is bid up relative to the discount rate until enough banks are "driven" to the discount window. The subsequent rise in the funds rate is then

Asia and Oceania Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF				
			6 months ending	12-month change	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use cred lions o
Asia	**Bangladesh**	Real growth expected to be slightly negative for fiscal year ending June 30.	Dec.	− 6%	12.0*	133	April	158	− 39%	0.7	37
	Burma	Real growth estimated at 6%-6.5% in fiscal year ended March 31.	Jan.	− 3%	5.3**	150	April	187	− 36%	7.1	5
	China, People's Republic	Strong recovery taking place in heavy industry.	Dec.	+ 3%	242.2†	246	Dec.	5,048	+ 98%	3.0	50
	Hong Kong	Government revenue and surplus for fiscal 1981-82 revised downward.	Oct.	+23%	24.3	4,710	n. a.	—	—	—	—
	India	Restrictions on industrial investment relaxed to spur production and exports.	Jan.	−22%	161.4**	236	Jan.	4,771	− 32%	4.6	1,31
	Indonesia	Victory by ruling Golkar party suggests no changes in economic policy likely.	Sept.	− 9%	77.5	500	March	5,235	− 15%	5.1	
	Japan	New period of inventory adjustment underway, with slowdown in exports.	March	+ 2%	1,126.8	9,559	April	26,845	0	2.2	
	Korea	Government extends tax and credit assistance to business.	March	+ 8%	63.4	1,630	April	3,037	+ 3%	1.4	1,31
	Malaysia	Development plan reassessment likely to result in scaling back, postponement of projects.	Dec.	−14%	24.2	1,742	Feb.	3,635	− 14%	3.6	21
	Nepal	Real growth near 3% expected for fiscal year ending June 30.	March	+ 9%	2.3*	165	Jan.	202	+ 14%	6.5	1
	Pakistan	Steps to restructure tax system and further liberalize imports expected to be announced soon.	March	−27%	30.6*	365	April	741	− 32%	1.7	91
	Philippines	Delay in world recovery depressing economic activity.	Dec.	−10%	39.7	801	April	1,964	− 22%	2.7	91
	Singapore	Economy grew at 7.3% annual rate in first quarter of 1982.	Feb.	+ 3%	11.6	4,780	Jan.	7,612	+ 15%	3.3	
	Sri Lanka	Rice and tea crops hit hard by drought.	Dec.	+ 3%	4.3	288	Jan.	380	+ 46%	2.7	38
	Taiwan	Investment tax credit extended another year.	Nov.	+19%	45.5	2,530	Dec.	7,235	+228%	3.5	
	Thailand	Revenue shortfall necessitates 4 billion baht reduction in government spending.	Jan.	+ 6%	36.1	760	April	1,490	+ 17%	2.0	67
Oceania	**Australia**	Arbitration Commission rejects unions' national wage claims; unemployment stands at 6.3%.	March	− 6%	156.0	10,500	April	2,680	+ 2%	1.2	
	New Zealand	Financing for $1.2 billion synfuel project finalized.	Feb.	+ 1%	24.4**	7,858	March	329	− 21%	0.7	2

*Fiscal 1980-81 **Fiscal 1981-82 †1980

supposed to depress the demand for money, and thus bring money back into the targeted range—just as it was under the old strategy.

Consequently, the effect on the federal funds rate of deviations of money growth from target is similar: Under the old strategy the explicit funds-rate target was changed; and under the new strategy, changes in the demand for reserves—relative to the supply of nonborrowed reserves—affect the funds rate relative to the discount rate.

Indeed, empirical research supports this assertion. When percentage changes in the funds rate were compared with deviations of money growth from target, the results for the pre-October 1979 period and the post-October 1979 period were quite similar in qualitative terms. One notable exception was that money growth had a much weaker influence on the funds rate during the period from 1978 to mid 1979, when G. William Miller was chairman of the Federal Reserve. In both the earlier period when Arthur Burns was chairman and the more recent period under Chairman Volcker, monthly percentage changes in the funds rate were significantly related to monthly deviations of money growth from target lagged from one-to-three months. Thus, the empirical results suggest that on average, the most recent period was more like the Burns period than the Miller period. The major difference between the Burns and Volcker periods is that, in the later, the funds rate moved almost 50% more in response to a given deviation of money growth from target.

While, *on average*, things may not be as different as they first appear, there have still been some striking changes since October 1979. For one thing, money growth has been much more volatile recently. For another, the relationship between discount-window borrowings and the funds-rate/discount-rate spread is notoriously imprecise and thus difficult to forecast in the short run. And, it has become even more volatile since the Fed changed operating targets. This is critical since under the current operating tactics, this relationship provides a major link between policy action and money growth. Finally, under the new tactics, it has become much more difficult to identify changes in Fed policy. Under the old operating procedures, it was fairly easy to tell when there had been a change in the funds-rate target simply by observing when the Fed intervened in the funds market. Today, however, it is difficult to tell from the behavior of reserves whether —or, equally as important, to what extent—the Fed has changed its policy stance.

When combined with the Fed's tendency to react more forcefully to the deviations from target of an inherently volatile money supply, these forces all have dramatically increased uncertainty over the interest-rate implications of current monetary policy. And this has continued to affect the financial markets adversely.

Thomas A. Lawler

F PAYMENTS		MONEY AND BANKING							COUNTRIES
of IMF it, mil- f dollars	current influences on payments	12-month changes				exchange rate in U.S. dollars June 2, 1982	change from year earlier	current monetary conditions	
		latest data	consumer prices	latest data	money supply(M1)				
5	Aid donors pledge $1.6 billion in new aid commitments.	March	+16%	Jan.	+ 4%	.0550	—12%	Bank borrowing for deficit financing to be near zero.	**Bangladesh**
5	Current-account deficit for fiscal year remained at about 6% of GDP.	Jan.	+ 2%	Apr.'81	+13%	.1319	— 9%	Kyat remains pegged to SDR.	**Burma**
8	Foreign trade ministry reorganized.	Dec.	+ 3%	Dec.	+19%	.5530	—15%	Money supply surged at the end of 1981.	**China, People's Republic**
—	Capital inflows increased since interest tax changes in February.	Oct.	+17%	Oct.	— 8%	.1736	— 5%	Money supply growth accelerates.	**Hong Kong**
7	Import restrictions liberalized significantly, particularly for productive inputs.	Feb.	+10%	Nov.	+13%	.1100	— 7%	Cash reserve ratio trimmed to ease credit situation.	**India**
0	Oil production has fallen below OPEC quota.	March	+10%	Dec.	+29%	.0015	— 6%	Rupiah slips against dollar.	**Indonesia**
0	Additional measures announced to alleviate trade frictions.	March	+ 3%	March	+ 9%	.004089	— 8%	Central bank supporting rates to help weak yen.	**Japan**
4	Growth of export letters-of-credit arrivals slows.	April	+ 9%	Feb.	+ 3%	.0015	0	Kerb market loan scandal depresses financial sector.	**Korea**
4	Crude oil prices reduced.	Jan.	+ 9%	Jan.	+11%	.4338	+ 2%	Government pledges tight control over money supply.	**Malaysia**
9	Policies enacted to spur exports, promote import substitution, curb luxuries.	March	+ 9%	Oct.	+14%	.0757	—13%	Foreign banks to be allowed to operate in Nepal.	**Nepal**
4	Growth of workers' remittances slows sharply.	Feb.	+10%	Feb.	+ 7%	.1000	— 2%	Modest reserve drawdown likely in fiscal year just ending.	**Pakistan**
9	First quarter current account gap more than doubled from year earlier.	Jan.	+18%	Feb.	+ 3%	.1230	— 8%	Central bank enters into deposit arrangement with Arab banks.	**Philippines**
0	Trade deficit increases, but reserves stand firm.	March	+ 8%	Jan.	+13%	.4763	+ 3%	Total bank asset growth stagnant.	**Singapore**
1	Additional food imports necessitated by poor crop outlook.	March	+13%	Feb.	+20%	.0500	—13%	Budget pressured by drought-related expenditures.	**Sri Lanka**
0	New Taiwan dollar drops marginally; exports slow.	Dec.	+18%	Dec.	+11%	.0258	—11%	Interest rates lowered.	**Taiwan**
5	Accord reached with EC limiting Thai tapioca exports.	March	+ 7%	Dec.	+ 2%	.0460	— 8%	Divestiture of finance companies proceeding slowly.	**Thailand**
0	Capital inflows revive to a record level in April.	Jan.	+11%	Feb.	+ 6%	1.0550	— 7%	Interest rates have risen.	**Australia**
7	Overall payments deficit for fiscal year ended March widened to NZ$1.14 bn.	Jan.	+16%	Feb.	+ 7%	.7585	—13%	Inflation-adjusted government bonds met strong demand.	**New Zealand**

World Interest Rates

market rates as of June 2, 1982; bond yields as of May 28, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	15.43	13.00 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.00	5.50	5.50
Day-to-Day Money	13.25 June 3	18 00	13.375	10.95	16.25	9.00	20.375	6.00	3.313 1-month Euro-Swiss fr. rate	7.125
Treasury Bills 91-day, Middle Rates	12.05 discount basis	15.60	12.625	15.00	n. a.	n. a.	18.952 85 days	no dealing	no market	5.625 two month
Commercial Paper prime, 3-month, asked	13.25 finance paper discount basis	16.00 finance paper 15% tax w/h	11.894	13.90 Certified	16.313 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.45	16.20 15% tax w/h	12.563	13.90 Certified	not traded	9.40	22.40	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	13.62	15.20	13.22	10.80 20% tax w/h	15.69	8.86	20.94	10.22	4.98	7.68
Industrial Bonds prime, long-term, new and old issues, average yield	14.95 Aa Industrials	15.50	14.60	14.737	16.74	9.00	20.79	11.08	6.025	6.67
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	17.00	14.00	17.50	18.05	12.50	21.75 ⅛ qtrly fee on outstdng.	10.50	9.50	6.00
Bank Time Deposits 3-month	13.625 Cert. of Dep.	16.00	13.00	14.65	16.313	8.90	11.50	8.75 large deposits	3.25 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	14.75	16.75	13.25	no market	28.75	8.75	no market	8.75	4.25	7.188
Exchange Rates—in U.S.$ rates floating against the $	—	0.803	1.793	0.023	0.162	0.423	0.001	0.379	0.497	0.004
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.949 *D*	1.772 *P*	1.932 *D*	12.951 *D*	6.304 *P*	9.511 *P*	6.255 *P*	10.672 *P*	7.970 *P*

Eurodollar Deposits
(London, interbank, bid)
June 3

7-day	14.125
1-month	14.4375
3-month	14.5625
6-month	14.625

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.174
U.S.-Canada Treasury Bills	−0.811
U.S.-Canada Finance Co. Paper	−0.582
Eurodollars-U.K. Local Auth. Deposits	−0.147

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.00
Over 7 yrs.	15.00
DM Bonds	
7 yrs. and under	9.125
Over 7 yrs.	9.125

Gold Price
London
afternoon fixing

318.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(April) 6.6	(March) 11.6	(April) 9.4	(April) 14.0	(May) 5.3	(May) 15.2	(April) 5.6	(April) 2.8
Industrial production*	(April) −7.4	(March) −10.4	(March) 0.4	(March) 0	(April) 0.8	(March) −1.5	n. a.	(April) 2.8
Trade balance† *(billions of local currency units)*	(April) −$0.32	(March) C$1.18	(Feb.) £0.17	(April) −FF10.25	(April) DM3.43	(March) −Lit.1,110	(April) −SF0.67	(April) ¥343
Money supply (M1)*	(April) 5.0	(April) −2.0	(March) 15.7	(Jan.) 16.0	(March) 2.8	(Jan.) 10.4	(Feb.) −6.0	(Feb.) 6.2
Velocity of money (M1)*	(March) −0.4	(Dec.) 17.7	(Dec.) −5.9	(Sept.) −3.6**	(Dec.) 7.1	(Dec.) 30.0**	n. a.	(Dec.) −5.2
Reserves minus gold *($ million, change from previous month)*	(April) 1,610	(April) 541	(April) −570	(Feb.) 163	(April) 763	(April) −1,877	(April) −59	(April) −272

* Percent change from 12 months earlier. **based on GDP † Figures are only for the month indicated

Japan: In Need of a Domestic Recovery

Last year, Japanese economic growth slumped to 2.9%, a substantial drop from 1980's 4.2% and the lowest rate of real growth since 1975. Had it not been for exports, growth would have been lower still, since net external demand contributed nearly three fourths of the 1981 advance. This year, as continuing trade frictions and the world recession grind down the rate of export growth, the Japanese desperately need a revival of economic activity on the home front to bring the economy out of the doldrums. However, there is little in the 1982 outlook that suggests more than a modest recovery of domestic demand. And unless the government decides to sacrifice some of its long-run policy goals for short-run fiscal stimulus, Japan seems destined to suffer another year of sluggish economic growth.

Japan's domestic recession has already lasted far longer than most forecasters had expected. A rebound had been widely forecast for the second half of 1981. However, historically high real interest rates and the continued structural adjustment of certain key industries to the second oil price shock have kept domestic activity at depressed levels. In addition, the government's repeated rejection of a tax cut out of concern for the size of the budget deficit has acted as a further drag on spending and investment.

Consumer expenditures and residential housing investment were particularly weak last year. Although the spring negotiations resulted in union wage increases averaging 7.7%, workers on the whole averaged increases of only 5% because of the depressed business conditions suffered by small nonunionized firms. Owing to a decline in overtime and bonus payments, as well as to larger social security payments and higher taxes because of bracket creep, real disposable income showed little, if any, increase in 1981 despite a sharp drop in the rate of inflation. As a result, consumer spending, which, in Japan, accounts for over 50% of GNP, rose only 0.6% in real terms. Residential housing remained severely depressed not only because of the sluggish behavior of real income, but also because of a sharp increase in home prices and adverse demographic trends.

Private investment in plant and equipment by large companies remained firm throughout the year. However, investment by small enterprises—some 60% of total investment in Japan—lagged as a result of the high real interest rates and weakness in consumer spending.

Exports served as the economy's main source of strength. But even this support gave way in the final quarter, when net exports plunged at a seasonally adjusted annual rate of nearly 57%. This led to an annualized 3.5% drop in real GNP in the fourth quarter—the first quarterly decline in almost seven years.

Some of the domestic sectors, however, actually showed modest improvement toward the end of the year: Consumer spending and private business fixed investment, in the fourth quarter, grew at annualized rates of 2.2% and 5.6%, respectively—hardier growth rates than either had shown in more than a year. Still, a sharp increase in business inventories indicated that an unwanted inventory buildup had occurred as sales fell below expectations. This suggested that another period of inventory adjustment would be needed to bring stocks back down to desired levels. The recent behavior of Japan's industrial production index suggests that this process may be currently underway. But, since inventories still appear to be rising, the adjustment is likely to take a while longer to complete.

Growth outlook for the rest of 1982

Although clearer-cut signs of an economic revival are expected to emerge later in the year, the current outlook suggests that 1982 will still show only lackluster growth. With trade pressures continuing, growth of Japan's external markets is likely to be moderate, even if exports pick up as the world recovery takes hold. Thus, any economic rebound for Japan will have to draw its major momentum from domestic demand.

An increase in consumer spending will be critical and is forecast. However, it is likely to be far from robust. Real consumption expenditures have been on the rise in 1982, according to recent data. Moreover, this spring's labor negotiations appear to have resulted in average wage increases of about 7%. While average overall wage increases may once again be somewhat less, the continued low rate of inflation and stepped up overtime and bonus payments as business activity recovers are expected to boost real disposable income and consumer spending. Nevertheless, any increase is likely to be modest because of the continued tax drag. Thus far, the Japanese government—still firm in its commitment to reduce its budget deficit—has given no indication that it is moving toward a tax cut.

Other sectors of the economy appear equally incapable of generating a strong rebound this year. Private plant and equipment investment by small businesses may pick up as consumer spending revives somewhat, but investment by large firms is expected to slow. Furthermore, residential housing is unlikely to show any substantial recovery from last year's depressed level owing to continued unfavorable price and demographic trends. Thus, for the year as a whole, real growth is expected to be a sluggish 2.1%—considerably weaker than many forecasters had projected earlier this year.

In addition, inflation could begin to accelerate by the end of 1982. Inflation improved dramatically in 1981—consumer prices rose just 4.9% on average compared with an average increase of 8% in 1980. And for 1982 as a whole, consumer price inflation is expected to average

Japan: In Need of a Domestic Recovery

(continued from page 7)

just 3%-3.5%. However, the relatively expansionary monetary policy that the Bank of Japan has been pursuing could begin to put upward pressure on prices by the year's end.

Continued trade tensions

Despite a marked slowdown in exports over the past several months, and recent steps to liberalize import restrictions, trade pressures on the Japanese are likely to remain intense.

The Japanese recorded a trade surplus of over $20 billion last year—the second largest surplus ever. Exports increased 17.9% in value and some 10.5% in volume, in spite of attempts to restrain exports, because of the strong non-price competitiveness of Japanese products and the weakness of domestic demand. At the same time, imports rose just 3.8% in value and actually fell 2% in volume terms, owing to the domestic weakness. Raw materials imports declined in volume because of the depression in Japan's basic materials industries and crude oil imports in particular dropped 10.6%.

With such a large increase in its trade surplus, Japan's current account registered a sharp turnaround to a surplus of $4.7 billion from a deficit of $10.8 billion in 1980. This was more than offset, however, by a $7.2 billion outflow of capital, attributable to Japan's relatively expansionary monetary policy. An excess supply of yen was reflected in lower real interest rates in Japan than in the United States. And as investors responded to the higher rates abroad, the inflow of capital to Japan slowed and capital outflow surged. As a result, the overall balance of payments was in deficit by $2.1 billion, and the exchange rate remained relatively weak, averaging 220.53 yen per dollar for the year.

In response to the persistent weakness of the world economy and increasing trade restrictions, Japan's exports have slowed dramatically in recent months. Except for January, which was a special case due to the bunching of exports of ships, exports on a seasonally adjusted basis have declined steadily since November and have been well below comparable levels of a year earlier. At present, export letters of credit fail to indicate a pick up anytime soon, despite the weak yen. And even as imports have remained depressed, the slowdown in exports has cut the seasonally adjusted quarterly current-account surplus to around $1 billion in the final quarter of 1981 and in 1982's first quarter—down from more than $2 billion in the third quarter of 1981.

Even with the striking slowdown in exports, Japan's 1982 trade surplus is projected to expand beyond that of 1981. Exports are expected to accelerate later in the year as recovery gets under way in Europe and the United States. However, growth will be more moderate than last year because of continued protectionist pressures. Imports, on the other hand, may start to pick up a little in the coming months, but on the whole are expected to remain extremely sluggish. Despite recent moves to encourage imports, the structural depression in the basic materials industry, combined with continued energy conservation and the decline of world oil prices, will work to keep the value of total imports low. As a result, Japan's trade surplus is expected to widen to $23.2 billion—a figure that may heighten the ire of its trading partners.

With the expanded trade surplus, the surplus of the current account is expected to rise slightly to around $6.3 billion. Nevertheless, if the Bank of Japan continues to follow a relatively expansionary monetary policy, the overall payments balance can be expected to remain in the red and the yen-dollar exchange rate is likely to average a weak 225-230 for the year.

Policy pressures

Concern that a weak yen could increase the trade surplus even further and thereby worsen trade frictions has apparently prompted some second thoughts about Japanese monetary policy. The monetary authorities have taken selective action in recent months in an attempt to directly control capital outflows and ease the downward pressure on the yen. In addition, the Bank of Japan has been intervening heavily in the domestic money markets to guide short-term interest rates higher or to at least prevent them from falling during the April-June seasonal surplus of funds. In fact, there is some evidence that the monetary authorities may have actually tightened somewhat during the process, pushing short-term interest rates back to the level they were at before last December's discount-rate cut.

Still, however, the outlook for the domestic economy over the next several months remains dismal. And with stimulative fiscal measures essentially precluded by the government's commitment to reduce the deficit, policymakers currently have limited means with which to spur domestic demand. Thus, monetary authorities are expected to maintain a reasonably expansionary monetary policy for a while longer. If, however, this stance results in a depletion of reserves and an acceleration of domestic inflation, the authorities could act to tighten significantly toward the end of the year.

In the event that the domestic economy fails to pick up, the government undoubtedly will be forced to reconsider its fiscal policy stance—including its position on tax cuts. Already, a supplementary budget is expected to be submitted later in the year calling for additional public works funds. And unless the economy bounces back stronger than is currently expected, another large revenue shortfall seems inevitable. This could force the government to finally abandon its goal of balancing the budget by fiscal 1985. *Melanie L. Lau*

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The Canadian Dilemma

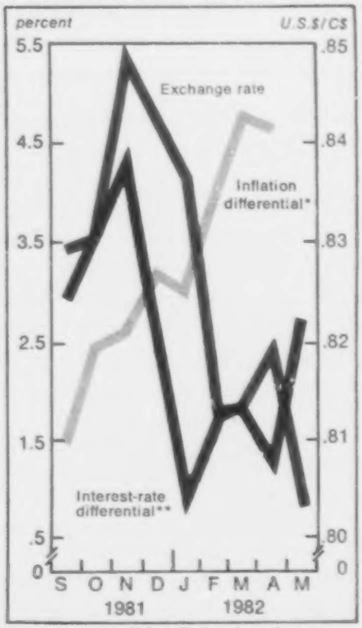
Canadian economic policymakers are faced with a number of extremely hard choices. The recession currently gripping the Unted States has had an even stronger impact on the Canadian economy. March industrial production in Canada was 11% less than the 1981 peak. Unemployment has risen to 10.2%. And unlike the U.S. experience, inflation has stayed stubbornly high, with the April Consumer Price Index up 11.3% over the past twelve months and wage increases from recent settlements tending around 12%. As a result, there has been growing pressure on the Trudeau government to take some policy action to get the economy moving again.

With high interest rates an obvious barrier to economic recovery, one suggested line of departure has been a loosening of the links between U.S. and Canadian monetary policy. The exchange market—already nervous because of the widening differential between U.S. and Canadian inflation and worsening prospects for resource prices—has responded with a sell-down of the Canadian dollar. As a consequence, the exchange rate has reached historic lows in spite of persistent large-scale intervention by the Bank of Canada.

This recent weakness of the Canadian dollar underscores the policymakers' dilemma. A decision to adopt a "made-in-Canada" interest-rate policy would almost certainly prompt a further selloff of the Canadian dollar, higher inflation, and, ultimately, renewed upward pressure on interest rates. Yet, maintenance of a significant spread between Canadian and U.S. interest rates, while implying a relatively stronger exchange rate and relatively lower inflation, threatens the possibility of a continued slide in output and employment if U.S. interest rates do not fall soon.

Given these circumstances, the government is now signaling that the policy package likely to emerge later this month or early in July will not represent a basic change from current policy. The most likely elements of the package are guidelines or controls over public-sector wages and some relaxation of the controls over foreign investment. How the exchange market will react to the package when it appears is uncertain. A clear rejection of the idea of an independent monetary policy will make for a less one-sided market for the Canadian dollar. But a package that offers little evidence of increased resolve to reduce the inflation differential between Canada and the United States would tend to confirm the bearish sentiments that now dominate.

Canada vs. the United States: Selected indicators



*Canadian minus U.S. inflation, based on year-over-year percentage change in Consumer Price Indexes

**Canadian 3-month prime finance company paper rate minus U.S. 3-month prime industrial paper rate

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Netherlands' economy expected to remain stagnant in 1982.

The Dutch Central Planning Bureau's latest forecasts project economic stagnation for the Netherlands this year, but a modest improvement in inflation compared with last year. Prices are expected to rise by between 5.5%-6% in 1982, versus 6.7% in 1981. In general, this should help to bolster Dutch exports, which are forecast to increase by 2% in volume despite a projected 12% fall in the volume of natural gas exports. However, the export strength will be more than offset by declines in private consumption, business investment, and housing construction. Against this background, Prime Minister van Agt is expected to present an interim 1982 budget to Parliament before the September 8 general election. At present, the budget proposals envisage spending cuts of some 12 billion guilders in an attempt to hold public sector borrowing to 8% of national income. This figure would equal about 9% if policies were to remain unchanged. Still, any immediate action the current government might take will have limited impact on the economy in 1982. With only half of the year remaining, significant changes in fiscal policy will not be effective before year-end, and the 1983 budget will be decided by the government that is formed after the September elections.

A shift in the trend of economic growth for Greek Cyprus.

The economic boom enjoyed by Greek Cyprus in the latter half of the 1970s appears to be over. Following the invasion and de facto partition of the island in 1974, Greek Cyprus grew at an average annual rate of some 12% so that by 1980 the national economy in real terms was some 15% larger than its pre-partition peak. The pace of growth has slowed considerably in recent years, however. Real GNP in 1981 advanced at a rate of only 2.6% following growth of 5.1% in 1980. Growth in 1982 is expected to accelerate modestly compared with last year, but it is clear that Cyprus' reconstruction period has come to an end. The government's Fourth Emergency Action Plan, which encompasses the period 1982-1986, projects that the real economy will grow at an average annual rate of 4%, based largely on expected capital intensive industrial growth. Foreign direct investment, which has grown rapidly since 1975, will continue to be encouraged and offshore banking institutions will be attracted. Tourism and manufactured goods, however will continue to be the main sources of foreign exchange earnings.

Continued depression in commodities forces Malaysia to rethink development program.

The government of Malaysia is being forced to back away from the expansionary fiscal policies that have characterized its development strategy in recent years. Persistently depressed commodity prices have resulted in widening budget and balance-of-payments deficits, putting pressure on the authorities to adopt a more austere development program—at least for the time being. The government has just announced that it intends to cut 10%-20% from this year's program. Defense spending is likely to be a prime target, but even government food and housing subsidies could be trimmed. In addition, some of the capital-intensive, heavy industrial projects are expected to be delayed or even scrapped in an effort to adjust to the adverse external circumstances.

Brazilian inflation and trade balance improving, but recovery is slow.

Brazil is making steady progress both in reducing its high inflation rate and in maintaining a foreign trade surplus position. Since late 1980, Brazilian economic policy has been shaped to lower inflation and improve the balance of payments through curtailing aggregate demand—and the government's efforts are at last beginning to yield the desired results. In the first five months of 1982, the annualized rate of inflation dropped to 91.2%, down significantly from 1981's 120.2%. In addition, over that same period, Brazil maintained a foreign trade surplus of $223 million. These gains, however, have been accompanied by a necessary slowing of economic activity. Last year real GDP declined a record 1.9%, and thus far this year there has been only slight evidence of recovery. The latest reported data show small increases in industrial activity and purchases of consumer durables. If these sectors continue to strengthen, the likelihood of positive economic growth for 1982 could be assured.

Ireland fighting uphill battle against huge budget and balance-of-payments deficits.

Ireland's new government, elected in March, has thus far remained committed to its tough policy stance, but is finding it increasingly difficult to maintain the firm posture needed to turn the troubled economy around. Real GNP in 1982 is expected to remain flat, at best, and the Irish central bank is even forecasting a 0.5% decline. Moreover, projections are that inflation will advance at a rate of more than 17% in 1982 and that the current-account deficit will be around £1.25 billion—some 10.5% of GNP. In addition, despite tax increases and expenditure cuts, the government's budget deficit will equal nearly 15% of GNP this year. To make matters worse, the government—which was elected by only the smallest of majorities—is now coming under strong public criticism for the big cuts in take-home pay stemming from increased contributions to the republic's social security system. As foreign exchange markets remain nervous about the position of the Irish pound, the Irish government is anxiously watching the economic situation elsewhere in Europe. Much of the new investment in Ireland has been in export-oriented industries, and an upturn abroad would strongly benefit Ireland's balance of payments and the domestic economy as well.

Paraguay's era of high growth may be ending.

Paraguay's years of 10%-plus rates of real economic growth may be coming to an end. Since 1977, the Paraguayan economy—bolstered by construction of the giant $18-billion Itaipu hydroelectric project—has been a standout among Latin American countries because of its high rates of real GDP growth. In addition, the country's large farming and ranching sector has sustained growth of over 8% per year in real terms. Last year, however, real GDP growth slowed to 8.5% as the economy was hit simultaneously by the winding down of the Itaipu construction, low agriculture prices, and recessions in neighboring Brazil and Argentina. The slowdown is persisting in 1982 and has been made worse by delays in starting an $8-billion joint-venture hydroelectric project with Argentina. Still, Paraguay's policy response has been one of fiscal and monetary caution, largely because of foreign exchange constraints. In this setting, prospects are that 1982 will show a lower—but still positive—rate of economic growth.

New technology critical to Taiwan's ambitious growth plans.

The government of Taiwan has set its sights on achieving 8% average annual real economic growth over the next four years. The latest four-year plan, covering the period 1982-85, calls for a major readjustment of Taiwan's trade and industry structure toward high value-added, high technology industries. In view of growing international competition in traditional labor-intensive products, priority will now be given to the development of "strategic" industries, including electrical and non-electrical machinery, transportation equipment, data processing, and electronics. A yearly growth target for this sector has been set at 14.4%, compared to only 6% for non-strategic industries. It remains to be seen whether Taiwan's overall growth aims are overly ambitious. At the moment, the economy is in somewhat of a slump relative to its past performance. Real growth for 1981 is estimated to have been only 5.5%, and despite a number of investment-boosting measures enacted by the government, little, if any, improvement is expected this year. The critical element to Taiwan's meeting its goal will be the speed with which it is able to develop or import the necessary new technologies.

Jordan enjoyed sound economy, lower inflation last year.

The Jordanian economy, led by an impressive 12.7% increase in industrial production, continued to exhibit strong growth in 1981. This was achieved by an 8.5% rise in phosphate production to 4.2 million tons as new capacity came on line and by further increases in manufactured exports to other Arab nations, particularly Iraq. The performance of Jordan's exports has been strong—up 48% to 169 dinar ($518 million). However, with domestic spending similarly buoyant, imports continued to grow by a rapid 46% to 1.05 billion dinar ($3.2 billion), implying a large rise in the trade deficit. The soundness of the Jordanian economy has also been reflected in last year's reduction in retail price inflation, down to a comfortable rate of 4.8% from 12.6% in 1980.

Will Consumers Lead the Recovery?

If the U.S. economy is going to pull out of the recession this year, most economists agree that consumers will have to lead the way. Recently, there have been some hopeful signs: Retail sales in May increased 1.5% after a 0.7% gain in April—the first reasonably hardy two-month performance since early 1981. In addition, the Conference Board's index of consumer confidence jumped 10% in May, after having declined for the previous year.

Consumer purchasing power will receive a $45-billion boost on July 1 from the 10% income-tax cut and the 7.4% cost-of-living adjustment to Social Security benefits. This and other developments will raise consumers' real income after taxes at an annual rate of better than 10% in the upcoming third quarter. It is still uncertain, however, how consumers will respond to this stimulus.

Normally, the prospect of a surge in real purchasing power would suggest a boom in consumer spending. For example, in the spring and summer of 1975, rebates on 1974 tax liabilities and a cut in 1975 tax rates boosted real disposable personal income by some 8%. Real consumption then rose at an annual rate of just under 6%, and a true recovery was under way.

These are not "normal" times, however. Unemployment is high and still rising, not falling as it was during the summer of 1975. In addition, mortgage and other interest rates have stubbornly remained at historically high levels, implying rising real interest rates as inflation slows. In contrast, real interest rates were less than zero in 1975. Moreover, in 1975, housing prices were rising at an annual rate of 10%. Currently, however, high mortgage rates are preventing existing home prices from rising and in many areas house prices are actually falling. Thus, homeowners, in general, are no longer enjoying capital gains that in the past had enhanced their spendable incomes.

Furthermore, consumers' willingness to buy on credit seems to have waned relative to earlier periods. The ratio of new consumer credit to disposable income fell one percentage point below its cyclical peak just before the 1975 recovery took off; this ratio is now three percentage points less than its early 1980 peak. Rather than signaling a pool of untapped consumer liquidity that could finance a rapid increase in expenditures, however, this greater reluctance to augment purchasing power by borrowing could be a fundamental and continuing reaction to the higher costs of credit.

These negative considerations do not necessarily imply that there will be no pickup in consumer spending—just that it may be much less than proportional to the rise in disposable income. However, if gains in consumption are to outlast the summer, consumer confidence must be further buoyed by a drop in interest rates and an improved labor market.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE			
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered
Argentina	Real GDP dropped 5.7% in first quarter 1982; investments off 24%.	Dec.	+ 8%	128.0	$4,547	Feb.	3,484	−23%	3.6
Bahamas	Tourist arrivals up 6% in March 1982 vs. year-earlier, but quarterly totals still below 1981.	Dec.	−16%	1.3	5,485	April	137	+20%	0.4
Brazil	Small upturn of industrial activity and employment may signal economic recovery.	April	−11%	284.8	2,307	March	6,225	+13%	3.4
Chile	Recession will be deep and long; GDP may decline 3%-8% this year.	March	− 2%	35.3	3,126	April	2,789	−15%	7.1
Colombia	Conservative Party candidate wins presidential election for term starting in August.	Feb.	− 1%	37.3	1,399	April	4,336	− 8%	9.6
Dominican Rep.	Salvador Jorge Blanco elected president; conservative economic management to continue.	March'81	+ 6%	7.3	1,314	April	184	+ 9%	1.5
Ecuador	Economic adjustment program being implemented following May devaluation.	April	−15%	13.4	1,634	April	621	−21%	3.2
El Salvador	Agrarian reform suspended.	Dec.	−12%	3.3	666	April	97	+ 6%	1.1
Guatemala	Petroleum law being revised in effort to stimulate investment.	Dec.	−10%	9.0	1,239	April	190	−51%	1.2
Honduras	No improvement in severe unemployment problem expected as economy continues to deteriorate.	Oct.	0	2.7	710	Feb.	103	−21%	1.3
Mexico	Tough new government austerity program will cut public spending and slow economic growth.	April	+ 4%	238.7	3,303	May	3,920	+15%	2.8
Nicaragua	Torrential rains caused extensive damage, particularly to roads and communication system.	Aug.	+27%	2.7	1,089	Nov.	123	+40%	1.7
Panama	Government sets $3.4 billion goal for public-sector investments during 1982-85.	Feb.	−33%	3.8	2,027	March	110	+37%	0.9
Paraguay	Delay of Yacyreta hydroelectric project will slow construction and business activity.	Feb.	−24%	5.4	1,664	April	798	− 1%	14.4
Peru	Industrial sector plagued by stiffer competition because of overvalued sol and import liberalization.	March	−17%	21.0	1,160	Dec.	1,209	−39%	3.7
Puerto Rico	Drop in employment caused by industry slowdown and public-sector austerity.	March	−16%	11.7	3,658	March	11,285*	+16%	18.0
Uruguay	Real GDP declined by about 1% in 1981; greater drop expected this year.	Dec.	− 7%	10.9	3,711	July '81	402	− 5%	2.9
Venezuela	No growth expected as fiscal and monetary policy tighten.	Feb.	− 8%	69.4	4,454	April	7,363	−13%	7.6

*Commercial bank deposits

Net Borrowed Reserves: a Misleading Indicator

The figure reported each week for net borrowed reserves (NBR) is probably the second-most closely-watched monetary statistic released by the Federal Reserve. Defined as the difference between reserves borrowed at the discount window by member banks and reserves held in excess of requirements, NBR is considered to be an indicator both of money market conditions and of Fed policy. Its erratic behavior, however, has cast doubt on its usefulness in either of these roles. For example, during a recent seven-week period, NBR plunged from over $1 billion to a net "free" position in which excess reserves exceeded borrowings—and back again to a large net borrowed position.

NBR has come to be relied upon as an indicator of money market conditions, because it usually leads short-term movements in the federal funds rate. Since banks are generally reluctant to borrow at the discount window over long periods of time, increases in borrowings are usually quickly refinanced in the federal funds market, driving up the funds rate. Similarly, declines in borrowings generally signal declines in the funds rate. This relationship is valid, however, only if the reported figure for NBR is close to the amount that banks desire and if the level of excess reserves is stable and close to zero. This may not always prove to be the case. For example, much of the recent volatility of NBR appears to be attributable to computer errors. In some other instances, a disproportionate amount of excess reserves may be held by some of the smaller regional banks that do not always immediately reinvest those reserves in the federal funds market. Under these circumstances, the usefulness of NBR as an indicator of money market conditions is severly diminished.

NBR is also problematic as an indicator of policy. Contrary to some simple interpretations, an increase in NBR does not necessarily indicate a Fed tightening. NBR and non-borrowed reserves, supplied through open market operations, must sum to required reserves. But under current Fed procedures, required reserves are determined by the level of deposits held in the banking system two weeks earlier. Consequently, for a given set of policy targets, changes in M1 tend to be self-correcting. For instance, if M1 rises, required reserves rise two weeks later. The Fed has a choice of policy actions: It can either accommodate the increase in money by raising its non-borrowed target to leave NBR unchanged, or institute a "passive tightening" by maintaining its non-borrowed target and allowing NBR to rise. The latter would push the funds rate up and slow money growth. However, because of this automatic stabilizing mechanism, and because Fed reserves targets are not announced, observers of NBR cannot know at any particular time whether a change in NBR represents an active change in policy or a passive reliance on existing policies. Thus, even if changes in NBR could be used to predict short-term movements in interest rates, they would not give a clear signal of the Fed's policy intentions over the longer term.

OF PAYMENTS		MONEY AND BANKING								
		12-month changes				exchange rate in U.S. dollars	change from year earlier		COUNTRIES
e of IMF dit, mil- of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	June 16, 1982		current monetary conditions	
0	Import restraints expected to result in 1982 trade surplus.	May	+128%	May	+132%	.000071	−73%	Interest rates decline as money supply eases.	**Argentina**
0	Private capital inflows rising.	Feb.	+ 7%	Jan.	+ 5%	1.0100	0	Bank loans up in January.	**Bahamas**
0	Imports decline faster than exports to produce trade surplus.	May	+ 91%	April	+ 74%	.0070	−44%	Open-market operations limit money growth.	**Brazil**
30	Current-account deficit may shrink to $2.6 billion from $4.8 billion in 1981.	April	+ 6%	Feb.	− 8%	.0247	− 9%	Real interest rates continue high.	**Chile**
0	Coffee export prices cut to stimulate demand.	March	+ 25%	April	+ 24%	.0167	−20%	Restrictions eased on private foreign loans.	**Colombia**
21	Int'l. payments prospects bleak owing to low world sugar and metal prices.	Oct.	+ 6%	Jan.	+ 12%	Par	—	Monetary policy is tight.	**Dominican Rep.**
0	New exchange rate may boost exports.	March	+ 14%	March	+ 11%	.0271	−23%	Rise allowed in interest-rate ceilings.	**Ecuador**
43	Land reform setback prompts U.S. Senate to slash Reagan military aid request.	Dec.	+ 12%	Jan.	− 2%	.4000	− 1%	Net foreign assets weak.	**El Salvador**
[illegible]	Bumper sugar crop of some 521,000 metric tons forecast for this year.	Dec.	+ 9%	Dec.	0	Par	—	Foreign exchange available in private banking system.	**Guatemala**
53	Agricultural production expected to drop because of torrential rains.	Dec.	+ 11%	Feb.	+ 1%	.5000	0	Net foreign assets down sharply.	**Honduras**
0	Oil exports rose in May.	May	+ 45%	Jan.	+ 33%	.0210	−49%	Money growth limited to net foreign-exchange inflows.	**Mexico**
22	Adverse weather indicates grain, coffee, and cotton production will fall.	July '81	+ 28%	Oct.	+ 44%	.0995	0	Net international reserves decline.	**Nicaragua**
39	New $225 million Euroloan secured.	Feb.	+ 5%	Dec.	+ 10%	Par	—	Domestic credit available.	**Panama**
0	Low commodity prices limit exports.	Feb.	+ 6%	Oct.	+ 8%	.0079	− 1%	Monetary policy is restrictive.	**Paraguay**
22	Mining output decreased 4.4% in 1981; no growth likely this year.	April	+ 61%	April	+ 46%	.00155	−38%	Reserve requirements reduced.	**Peru**
—	Exports to non-U.S. markets increased.	April	+ 5%	March	+ 7%	Par	—	Business loan growth slows.	**Puerto Rico**
0	Devaluation pace for Sept.-Oct. accelerated to 30% per annum.	March	+ 22%	Dec.	+ 7%	.0867	− 7%	Real interest rates remain high.	**Uruguay**
0	OPEC production strategy working; Arab marker crude recovered to $34/barrel.	April	+ 1[illegible]%	Dec.	+ 10%	.2335	0	Deposit growth continues flat.	**Venezuela**

World Interest Rates

market rates as of June 16, 1982; bond yields as of June 11, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	16.20	12.50 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.00	5.50	5.50
Day-to-Day Money	14.375 June 17	16.00	12.75	12.50	16.00	9.00	20.50	9.00	5.375 1-month Euro-Swiss fr. rate	7.375
Treasury Bills 91-day, Middle Rates	12.33 discount basis	16.20	12.25	15.00	n. a.	n. a.	18.60 71 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	13.75 finance paper discount basis	16.85 finance paper 15% tax w/h	11.60	13.90 Certified	15.63 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.05	16.65 15% tax w/h	12.25	13.90 Certified	not traded	9.40	22.50	no market	6.00	no market
Government Bonds Long-term, new and old issues, average yield	13.91	16.00	12.97	10.82 20% tax w/h	15.70	9.06	20.84	10.33	4.75	8.00
Industrial Bonds prime, long-term, new and old issues, average yield	15.15 Aa Industrials	17.40	14.51	15.48	16.70	9.25	20.84	11.16	6.113	6.69
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	17.50	13.50	17.50	18.05	12.50	21.75 ⅛ qtrly fee on outstdng.	10.50	9.50	6.00
Bank Time Deposits 3-month	14.25 Cert. of Dep.	17.30	12.75	15.00	15.625	9.00	11.50	9.00 large deposits	4.75 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	15.563	17.250	12.875	no market	16.625	8.875	no market	8.938	5.438	7.250
Exchange Rates—in U.S.$ rates floating against the $	—	.7792	1.751	.0215	.1480	.4104	.00073	.3724	.4762	.00394
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	1.734 *D*	2.843 *P*	1.975 *D*	1.077 *D*	6.794 *P*	5.464 *D*	6.758 *P*	10.374 *P*	8.394 *P*

Eurodollar Deposits

(London, interbank, bid)
June 17

7-day	14.75
1-month	15.063
3-month	15.625
6-month	15.75

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.593
U.S.-Canada Treasury Bills	−1.293
U.S.-Canada Finance Co. Paper	−1.135
Eurodollars-U.K. Local Auth. Deposits	− .093

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.43
Over 7 yrs.	15.50
DM Bonds	
7 yrs. and under	9.31
Over 7 yrs.	9.31

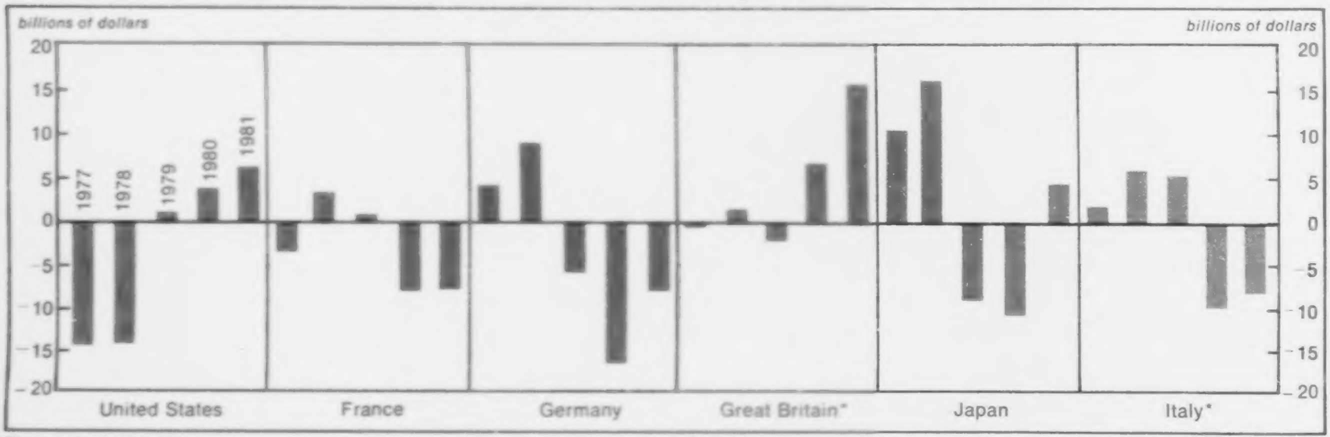
Gold Price

London
afternoon fixing

317.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current-account balances of major industrial countries



*Chase estimates for 1981

A Long Road Back for Thrifts

The recent upturn of interest rates is the latest—although undoubtedly not the last—turn of the screw for beleaguered savings and loan associations (S&Ls) and savings banks. While at current levels short term rates are still below those in the earlier months of 1982, on average thrifts will require considerably lower interest rates to attain anything approaching healthy earnings. Moreover, even with the lower rates, a lag of as much as 6 to 12 months will be required before funding costs will incorporate the lower rates to an extent sufficient for a material turnaround of profits. And finally, whether consumer deposit flows will revive as earnings strengthen is a particularly worrisome question. In this light, it seems doubtful that a strong improvement in new lending activity by thrifts—and, by extension, new housing activity itself—will materialize during the next 12 months.

The principal cause of the deterioration of S&L positions has been the rapid rise of their funding costs relative to returns on mortgages (see chart). In the second half of 1981, the margin between average mortgage returns and average funding costs for S&Ls fell to a negative 150 basis points. Even during the high-rate environment of the mid-1970s, this margin did not fall below a *positive* 125 basis points. The 1981 slump entailed an operating loss in excess of $4.5 billion, and since year-end 1980 the ratio of net worth to total assets has dropped to 3.8% from 5.3%.

The dramatic rise in thrifts' costs has reflected the sharp increase of short-term interest rates and also the greater recourse to interest-sensitive money market vehicles for funding. At the same time, however, the bulk of S&L mortgage holdings—which constitute about 80% of their interest-bearing assets—still carry interest rates well below current funding costs. According to a recent Federal Home Loan Bank study, at the end of 1980 about two-thirds of S&L mortgages carried interest rates of 10% or less, and three-eighths of the total had rates less than 9%. But even the newer mortgages, with rates above 10%, have also meant problems. During parts of 1979-80 and most of 1981, extensions of new mortgages were being made at times when there was a relatively small spread between costs of new money market funding and new mortgage yields. Thus, in the short run, the new lending contributed little to S&L interest margins. As interest rates continued to rise, sizable amounts of relatively new mortgages joined old mortgages "under water" relative to funding costs.

Recent policy measures

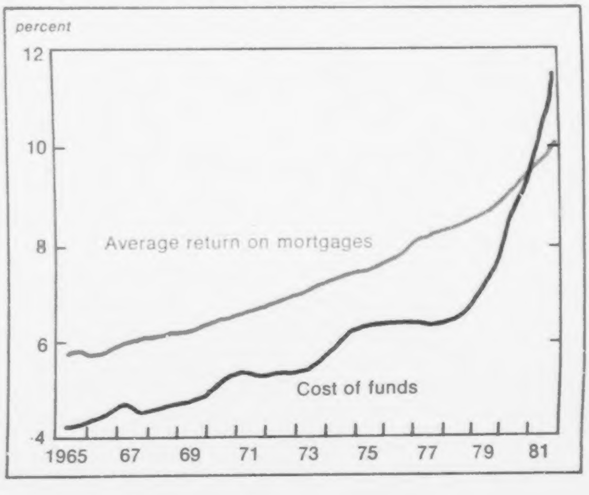
Within the last two years the government has initiated a number of new policies directed toward alleviating S&L earnings problems—either by changing certain aspects of the mortgage instrument itself or by affecting the profitability and capital of the thrifts.

On the mortgage side, under omnibus banking legislation in 1980, state usury ceilings on mortgages were preempted and thrift operating powers were expanded. In another move in 1981, the Federal Home Loan Bank Board (FHLBB) removed previous limits on the size and frequency of interest-rate changes for adjustable-rate mortgages. According to the revised regulations, contract rates may now be tied to any index that is easily verifiable.

While these two steps encouraged *new* mortgage activity, a third has addressed the *old* mortgage problem. As such, it may play an important role for many institutions' near-term profit performance. Specifically, accounting conventions have been adopted to permit changes in the time-pattern of returns on "underwater" mortgages. Under this program, the carrying values of mortgages may be reduced to their current market valuation on the basis of current interest rates and remaining term to maturity. Thereupon, in addition to the stated interest, part of the accretion of value between the market value and the original stated value may be taken into income. The estimated accretion is based on the expected *effective* maturity of mortgages, rather than the *stated* maturity. Typically, a new mortgage having a 30-year original maturity will be liquidated in approximately 10 years. On the other side of the ledger, the valuation loss represented by the markdown of old mortgages to current market value (to be carried as an asset, "good will") may be written off against earnings over the period of the remaining term to *original* maturity.

Several other measures relating to profitability and capital have been undertaken or are under consider-

The source of recent S & L difficulties



A Long Road Back for Thrifts *(continued from page 7)*

ation. In 1981, S&Ls were authorized to trade in financial futures. This power, along with adjustable-rate mortgages, is critical to the better management of interest-rate risk. Another measure, now before the Congress, would authorize capital contributions to thrifts (and also banks) experiencing serious erosion of net worth. The infusion would not be cash per se, however, but rather, an interest-bearing certificate. In effect, this legislation would seek to "buy time"—that is, to forestall supervised mergers or liquidations of those entities deemed to be temporarily weakened.

This "buying time" approach seems to have considerable appeal to policymakers. First of all, the legislation would insulate against the need for supervised consolidations if net worth of a thrift institution fell below the minimum acceptable level—a strong plus since the commitment of funds needed for such actions could be sizable. Second, regulators and legislators, thus far, have demonstrated considerable aversion to commercial bank acquisitions of S&Ls. Indeed, public officials convey the distinct impression that consolidations with commercial banks would be tolerable only if no other alternative is available.

One reason for the policy aversion to bank-S&L consolidations has been concern that interstate banking restrictions at the consumer level would effectively be breached. In a variety of ways, of course, this has already happened. And new developments now in the works, such as the sharing of automated teller machines, will further reduce interstate barriers. Another impetus has been desire on the part of the thrifts to preserve their separate identity as an industry (and certain regulatory preferences associated therewith). And a third has been uncertainty over the source of housing finance in an era of less specialized, multi-purpose deposit intermediation. On this count, however, recent history strongly suggests that specialization has enhanced the vulnerability of the S&Ls and hence reduced the availability of housing credit.

In a longer-term perspective, the FHLBB has proposed a substantial expansion of the list of services S&L subsidiaries are permitted to perform. The list includes: broadly expanded leasing and lending, securities brokerage, futures positioning, mutual fund distribution and management, general insurance underwriting, and real estate brokerage and development. A final decision by the board is believed to be imminent. While such authorization would have relatively little effect on S&L profitability in the immediate future, over time, strong and aggressive S&Ls would be in a position to significantly enhance their positions as sources of a wide range of financial services. Furthermore, the expanded services would make S&Ls more attractive acquisition prospects.

Interest rates and earnings

In the final analysis, a substantial improvement of S&L earnings still hinges on lower interest rates. Lower interest rates would reduce, if not eliminate, the drag on earnings from the low-rate mortgages that are such a sizable component of many S&L portfolios. Moreover, the positively sloped yield curve in effect for the past six months or so provides an attractive margin for new mortgages. As of mid-June, short-term interest rates (as reflected by the 6-month Treasury bill rate) were almost 350 basis points below new conventional mortgage yields. Intermediate-term Treasury issues have been approximately 150 basis points over 6-month bills. While the short funding of fixed-rate, long-term mortgages imposes the risk of rising interest rates, tying mortgage returns to instruments such as 3-year Treasury coupon issues would still provide a positive net return and reduce the interest-rate risk.

Whether deposit growth will benefit from lower interest rates is uncertain. The shift of consumer savings to money market mutual funds has been especially painful to S&Ls. Accelerating deposit volumes are critical in that they are the key to stronger asset growth, which in turn is a key to improved earnings on a sustained basis.

Current projections are that for S&Ls to return to a "break even" point would require a fall in short-term interest rates to at least (roughly) 10%. This prospect is also predicated on at least four major conditions: (1) a more or less constant composition of S&L funding between lower-rate "core" deposits (such as passbook savings and NOW accounts) and rate-sensitive funds, (2) growth of new mortgages at a rate comparable with that of liabilities, (3) a somewhat better rate of turnover of old mortgages than has been experienced recently, and (4) moderately strong—8%-10%—net growth. The 10% interest-rate threshold would have to be even lower if there were a materially faster shift from core deposits to other liabilities, if net new funds were allocated to market instruments of relatively short maturity (where spreads are smaller), or if the turnover rate or asset growth were lower. Thus the "magic" 10% rate level is virtually surrounded with caveats.

There are signs that thrifts are recognizing the serious long-term risks of their deposit losses. After a period of primarily defensive strategies, thrifts seem to be moving toward a more vigorous marketing stance. The development of new mortgage and deposit-like services and extended promotion efforts are indications of a new resolve toward market positioning. If sustained, and if the interest-rate decline materializes, thrifts may be establishing the groundwork for a major period of recovery.

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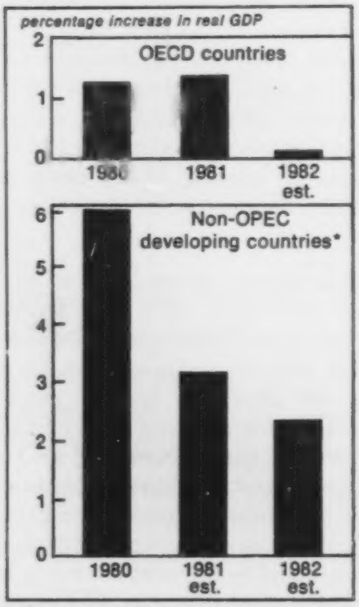
Slower Growth in the Developing Economies

The growth slowdown that has gripped the industrialized economies for the past two years is now a global phenomenon. Last year the weighted average increase of real GNP in 22 non-OPEC developing countries, including the 16 largest other than the People's Republic of China, was about 3%—down sharply from the roughly 6% increase recorded in 1980. This year the projected increase in output for this set of countries is even less—2.3%, approximately the same as their population increase. But while overall growth in these economies in 1982 is not expected to be all that different from their performance in 1981, the aggregate numbers tend to hide the fact that this year's slowdown is far more widespread. The abrupt deceleration of real GNP in the non-OPEC developing countries in 1981 was largely confined to Latin America, with significant output declines in Argentina and Brazil contributing heavily to the zero-growth record of the region as a whole. This year, even the high-flying economies of East and Southeast Asia will register markedly lower increases in the level of economic activity.

Growth of developed and non-OPEC developing economies



* Aggregation of 22 countries.

This decline in the growth momentum of the developing countries further clouds the prospects for a significant early recovery in the industrialized economies. Over the period 1976-81, the volume of exports from the industrialized nations to the non-OPEC developing countries grew at an average annual rate of 7.4%. Although data are fragmentary, the evidence now suggests that this important segment of world trade is contracting in real terms. In the 14 non-OPEC developing nations for which complete trade data are available, the volume of total imports in the first quarter of 1982 was down approximately 7% from the same period in 1981. And with an increasing number of countries encountering balance-of-payments funding difficulties, this decline in developing-country imports seems likely to continue.

The exports of the non-OPEC developing economies are also falling, but by a smaller amount than imports. Earlier projections that the balance-of-payments funding needs of this set of countries would be the same or slightly larger this year than in 1981 now seem overstated. The forecast reduction in the deficit on merchandise trade of the non-OPEC developing economies, stemming from their slower growth, appears likely to outweigh the continued deterioration of the services balance. This would leave the overall funding gap for 1982 somewhat reduced from last year's level.

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Decline in British interest rates likely—but may be limited.

Recent statistics show that the growth of Britain's money supply is now within the government's 8%-12% target range—the first time that its monetary objectives have been met since the Thatcher government came to power in 1979. This and a steady decelaration in inflation have led to expectations that a significant reduction in interest rates from the 12%-13% levels seen in recent weeks is imminent. However, the scope for a decline may be limited by the strength of the dollar, which has taken sterling's exchange rate close to 1.70, the lowest in five years. Although sterling has been reasonably strong against most other currencies (it has again risen to 4.30 against the DM) the sterling/dollar rate still plays an important role in influencing Britain's inflation rate. The government is not likely to want to see any further sterling weakening for fear of the effects on the anti-inflationary stance of its policies. Thus, despite the high probability of a small reduction in U.K. interest rates, a large and sustained decline must wait for the emergence of a similar trend in the U.S. economy.

No rebound for the German economy this year.

The latest figures show a distinct weakening of the German economy. Industrial production was off in late spring and industrial order volume declined markedly—largely the result of an 8% fall in orders from abroad. On a more positive note, inflation pressures have eased: Industral unit labour costs in the first quarter have risen by less than 3% and import prices in May were up only 0.5% from their year earlier level. Annualized consumer price inflation in the first half of 1982 was under 4%, and no underlying acceleration is expected. Accordingly, the Bundesbank appears to have shifted to an easier monetary stance: Discount quotas were raised by 5 billion DM in June despite rising dollar interest rates and "Central Bank Money" has been allowed to grow somewhat above the upper end of the 4%-7% target range. Nonetheless, the easier monetary conditions are unlikely to stimulate domestic demand before early 1983. Consequently, 1982 will be another disappointing year, with economic growth virtually certain to fall short of the government's 1%-1.5% forecast.

Forecasts of Austrian economic recovery may prove optimistic.

Some signs of recovery have emerged in Austria, prompting the nation's two leading economic research institutes to forecast growth rates of 1.5%-2.1% for 1982, with an acceleration to 2.5%-2.9% next year. Both institutes see the rebound as consumption led; investment is expected to decline by between 2%-3% this year and to recover only weakly next year. Inflation is expected to decline, both this year and next, to about 5% in 1983. While the inflation forecasts appear to be on target, the growth forecasts might prove somewhat optimistic for Austria's export-dependent economy. Recent indicators in Germany—Austria's single largest export market—point to weaker-than-previously-expected growth, which could affect Austrian exports and reduce the anticipated improvement in the current account of Austria's balance of payments.

Argentina strives to reactivate economy despite high inflation.

The Argentine government has initiated a number of measures to see the economy through its current troubled times. Following a 21% peso devaluaton and the creation of a two-tier foreign exchange market, merchandise exports and imports were placed in a commercial market with the exchange rate set daily by the central bank. All other transactions will clear in a financial market in which the rate is floating. In addition, a two-tier local-currency market has been created, with controlled deposit and loan rates in one segment and free rates in the other. The controlled market offers government-guaranteed deposits and negative interest rates on loans in an effort to bolster business liquidity. Companies that increase employment will get preferences in the controlled market. Credit expansion in the free market will be regulated by the central bank to avoid inflationary money growth. Banks are being encouraged to extend debt maturities for both foreign and local-currency loans. Other measures include forward exchange cover for foreign loan extensions. Yet, with wholesale price inflation averaging over 170% in the past year, initial business reaction to the program has been cautious and a period of market testing will be needed to gauge the response.

Chile devalues peso to help stem rising social costs of recession.

The specter of a severe and prolonged recession prompted strong policy actions in Chile last month. Most significantly, the Chilean authorities broke away from the three-year fixed parity policy and, on June 14, devalued the peso by 18% to 46 pesos per dollar. This is to be followed by an 0.8% monthly devaluation against a basket of currencies over the next year. In addition, measures were introduced to contain the growth of real wages and of a budgetary deficit that was developing rapidly as a direct result of the economic deterioration. By lowering local operating costs and restoring some of the peso's international competitiveness, these measures ought to contribute to reducing the costs of the recession in terms of bankruptcies and unemployment. However, this will happen only if the exchange rate adjustment is perceived to be adequate in light of the considerable overvaluation of the peso that has occurred over the past three years. This is crucial to avoid stimulating speculative capital outflows or discouraging external borrowing and to keep domestic interest rates from rising even higher as a result of greater demand for local funds.

Growing external debt burden weighs heavily on Sri Lanka.

The big surge in investment spending undertaken by Sri Lanka since 1977 has been financed largely through foreign savings. Consequently, the country's level of public and publicly-guaranteed external borrowing has risen rapidly in recent years: External debt outstanding climbed to $1.76 billion by the end of 1981, some 40% of GDP, compared with $782 million or 20% of GDP at the end of 1977. Particularly noteworthy has been the increase in commercial borrowing, which rose to $472 million or 26.8% of total debt at the end of last year from only $42 million or 3.8% of total debt just two years earlier. The high cost of this recent commercial borrowing, added to the repayment of outstanding loans from the IMF, pushed Sri Lanka's debt-service ratio to .17 in 1980 and 1981 from .13 in 1979. Given the poor medium-term prospects for exports, the debt burden could rise even more rapidly over the next several years unless steps are taken to boost domestic savings and to contain commercial borrowing, in particular.

Hong Kong monetary authorities demonstrate desire to stimulate economy.

The generally tight connection between Hong Kong's interest rates and world market rates may be loosening up somewhat. In response to an easing of monetary policy, the Hong Kong Association of Banks at the end of May lowered prime loan rates by one percentage point to 15%—the first such decline since last December. Underlying the monetary easing was the authorities growing impatience with sluggish export markets and a stagnant real economy. In the first five months of this year, exports rose only 6% in value and were flat in volume terms—a disappointing performance for this high-growth, export-dependent economy. The domestic sector has not been strong either. There was, however, some good news: Inflation slowed and capital inflows increased in response to tax measures taken in February. This apparently gave the government room for maneuvering.

Current-account surplus of United Arab Emirates contracting as oil revenues wane.

The continued softness of the world petroleum markets is shrinking the current-account surplus of the United Arab Emirates. Last year, the federation's export revenues fell by 4% as oil receipts suffered from an 18% drop in output that more than offset an increase in the average per barrel price to $36.15. At the same time, UAE imports of goods and services, as well as transfer payments, rose by an estimated 8% to $13 billion. This resulted in a substantial contraction in the current-account surplus to $8 billion from $10 billion in 1980. The erosion of the surplus is expected to be even larger this year, however. Reflecting the weakness of world demand, oil prices were reduced in the first quarter and are likely to average $34.50 in 1982—almost 5% lower than last year. Oil production is also down sharply and is expected to average no more than 1.3 million barrels per day compared with 1.5 mbd in 1981. If this forecast proves to be correct, gross oil revenues could drop 21% this year to $15 billion and total exports to about $17.5 billion. Furthermore, should imports and transfer payments rise again by a modest 8% to $14 billion, the UAE would register a current-account surplus of no more than $3.5 billion.

BEST AVAILA

An Easing of Pressures on the Fed

Policymakers at the Federal Reserve can breathe a little easier now. After having one of the key policy variables—the money supply as measured by M1—above the upper end of the Fed's target range for the first half of the year, M1 finally declined sufficiently in late June to fall within the target bands. In fact, by falling some $9 billion in the three weeks ending June 30, M1 was dangerously close to the lower end of its target. This information was favorably received by the financial markets, with drops of more than 100 basis points in 3- and 6-month Eurodollar rates to levels below 15%, and similar declines in rates on futures for September and December delivery.

It is unlikely that these declines could have occurred without such a dramatic fall in the money supply. The higher interest rates earlier in June reflected the market's anticipation of a huge increase in M1 in the statement week ending July 7, and of subsequent tightening by the Fed. As of now, however, even after last Friday's most recent jump in M1, the Fed is not in any serious danger of exceeding its targets by year-end.

Of course, the possibility still exists of a reacceleration of money demand later in the fall. The question of whether short-term interest rates would rebound accordingly, however, is not clear. If M1 does not rise far enough to exceed the upper end of its target, there is no reason to expect the Fed to tighten, pushing rates up. In fact, the possibility of another firming move becomes more remote as the year progresses with M1 still within target.

The relationship of M1 to its targets and the recent behavior of the money supply are certain to be of prime importance in Fed Chairman Volcker's congressional testimony this week. Previously, there had been speculation that he might propose raising the 1982 targets—either explicitly or by raising the base to which the targets are applied. This now seems unlikely, however. With the July bulge past and—because of the previous declines in M1—not particularly damaging, pressures to bring the aggregate back into target have subsided. Moreover, there have been some positive signals about the state of the economy: chiefly, improvements in retail sales (despite the June decline, they have risen at a rate of 6½% since January) and the positive "flash estimate" of GNP. Volcker now has some evidence to counter charges that the restrictiveness of monetary policy has retarded the prospects for economic growth. Consequently, there will be fewer pressures on the Fed to propose expansionary targets for 1983, as the chairman can point to the improvements on the inflation front as evidence of the benefits successively lower monetary growth targets have brought.

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE O				
			6 months ending	change from year earlier	in billions of dollars	$ per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of credit, llons of
Africa	Algeria	State oil company cutting down liquified natural gas expansion plans.	April	−28%	36.0*	1,935	May	3,012	−16%	3.7	
	Botswana	Slump in diamond prices forces belt-tightening; personal tax increases being considered.	March	−41%	1.1	1,280	May	286	−14%	4.7	
	Cameroon	Draft budget for fiscal 1982/83 shows 29% increase in government spending.	May '81	−21%	7.8	890	Dec.	85	−55%	0.5	
	Egypt	New five year plan (1983/84-1987/88) approved; program aims for 8% annual economic growth.	Dec.	−11%	22.7*	535	Jan.	1,354	+35%	2.0	8
	Guinea-Conakry	Hosting of 1983 OAU Conference will lead to major building program.	n. a.	—	1.5	270	n. a.	—	—	—	—
	Ivory Coast	Cocoa crop forecast to exceed last year's 405,000 tons.	Nov.	−28%	9.8	1,190	March	4	−73%	0	35
	Madagascar	Economy appears to be stabilizing after last year's 9% decline in output.	Dec. '80	−27%	3.8	420	May '80	9	−80%	0.2	8
	Morocco	New foreign investment code allows 100% foreign equity holdings in domestic companies.	Nov.	− 1%	18.1*	896	April	499	+89%	1.5	74
	Nigeria	Compulsory import deposits and increased import duties hamper industrial output.	April	−34%	86.8	1,125	April	1,237	−86%	0.8	
	South Africa	Real economic growth expected to slow to 1% this year and to zero in 1983.	April	−25%	81.9	2,720	May	503	−44%	0.3	
	Sudan	Lack of foreign exchange for essential imports hampers industrial production.	Dec.	− 2%	9.0	482	May	21	−28%	0.2	52
	Tunisia	Agricultural sector to receive investment funds of $2.6 billion—19% of total—during 1982-86.	Dec.	+ 2%	8.1	1,240	May	496	− 6%	1.5	
	Zimbabwe	Budget deficit near $500 million expected to bring spending cuts and higher taxes.	Aug.	+22%	6.2	815	Sept.	200	−37%	1.6	
Middle East	Kuwait	Consumer price index rose 7.3% in 1981, marginally higher than the year before.	April	−27%	26.5	18,070	May	4,170†	+ 7%	7.0	
	Oman	Government budget projects 1982 expenditures of $4.3 billion, up 6% from previous year.	April	− 1%	4.8*	5,380	April	1,080	+21%	7.7	
	Qatar	Qatar Petrochemical Company raising $60-million Euroloan.	April	−32%	5.0*	23,100	Sept.	347†	−10%	2.5	
	Saudi Arabia	State's Public Investment Fund to lend $790 million to SABIC-Dow Chemical joint venture.	April	−17%	117.6*	14,050	May	32,219†	+15%	11.5	
	United Arab Emirates	Federal government has established industrial bank to finance private sector projects.	April	−21%	19.4*	23,000	May	2,953†	+24%	4.0	

*1980 †Excluding state reserves

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Will High Unemployment Undo Disinflation?

With unemployment holding at 9.5%—the highest rate since 1941—and threatening to move higher, there so far have been remarkably few voices raised in favor of expansive policy actions to stem the rising jobless rate. To the contrary, political pressure to reduce federal spending and maintain current monetary policy continues because of fears of the possible future inflationary potential of the huge government deficits. There are some warning signs, however, that public opinion may be shifting, and calls for more stimulative fiscal and monetary policy could become louder and more common. Such a policy switch would, of course risk losing some of the gains made against inflation.

Part of the reason that unemployment is so high during the current slump is the extraordinarily high rate of 6% at the end of the last major expansion. During the 1950s and 1960s, 3%-4% was the prevailing rate before a downturn. The secular increase in the underlying unemployment rate during the 1970s can be attributed to a variety of government programs that reduced the burden of being unemployed, including more generous unemployment insurance. Shifts in the composition of the labor force—toward groups that change jobs more often and thus have higher recorded rates of unemployment—also played a role.

Taking this higher base into account, the increase in unemployment in the past two and a half years has been a normal cyclical development. The average increase in the unemployment rate in the last three recessions was 3.2 percentage points. So the 3.5-percentage-point increase so far during the current slump is only slightly worse than average.

Although the total increase in unemployment is not exceptional in terms of past recessions, the length of time over which the rise occurred is much longer than usual. Moreover, the average duration of unemployment has risen to 16.5 weeks, higher than in any year since 1950.

What may have made the cost of recent unemployment bearable to both policymakers and the unemployed is the growing realization that expansive fiscal and monetary policies in the past made only temporary inroads on unemployment, and that sustainable, non-inflationary growth in the private sector offers better prospects for permanently lower unemployment. But with the current success of the anti-inflationary efforts, these groups may now shift their focus to hopes for a drop in the unemployment rate. If the widely anticipated recovery fails to take hold in the second half of the year—or is so weak or short that unemployment continues to rise—calls for additional government spending or a less restrictive monetary policy can be expected to grow much louder. If they are heeded, however, the consequences are predictable: a reacceleration of inflation, with no more than a temporary reduction of unemployment.

F PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				exchange rate in U.S. dollars	change from year earlier		
IMF mil- ollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	July 14, 1982		current monetary conditions	
0	Oil output averaged 649,000 b/d Jan.-Apr., 26.9% below year earlier period.	Dec. '80	+10%	Nov.	+18%	.2270	+ 1%	Islamic Development Bank to lend $15 million.	**Algeria**
0	Arab lenders supply financing for $55 million Gaborene international airport.	Oct.	+14%	Feb.	+29%	1.0800	− 4%	Commercial bank liquidity is tight.	**Botswana**
8	Soon-to-be exploited iron ore deposits at Kribi should boost exports.	Aug.	+ 9%	Dec.	+24%	.002886	−16%	Liquidity appears adequate.	**Cameroon**
0	Three significant Gulf of Suez oil discoveries made in 1982 first quarter.	Jan.	+11%	March	+31%	1.2000	−16%	National Bank offers $30-40 mn. of floating rate Eurobonds.	**Egypt**
—	Heavy interest payments on foreign debt keep current account in deficit.	n. a.	—	—	—	.0440	− 4%	Severe foreign exchange shortage continues.	**Guinea-Conakry**
9	Coffee harvest down in 1982, but huge stocks will buffer exports.	Jan.	+13%	Dec.	+ 6%	.002886	−16%	Government credit requirements high.	**Ivory Coast**
8	No significant pick-up in exports foreseeable this year.	May '81	+39%	—	—	.002955	−14%	Cash flow problems continue.	**Madagascar**
6	Phosphate rock avgd. $44.67/ton in 1st qtr.—9.8% below 4th qtr. 1981.	Dec.	+13%	Dec.	+15%	.1900	+ 5%	Agreement signed for $70-million medium-term Euroloan.	**Morocco**
0	Import restrictions continue in view of depleted foreign exchange reserves.	Dec.	+17%	Feb.	+ 5%	1.4700	− 4%	IMF loan of $730 million helps replenish reserves.	**Nigeria**
0	Weaker rand and 10% import surcharge have begun to restrain imports.	April	+17%	March	+38%	.8700	−23%	Credit expansion to Land Bank boosts money supply.	**South Africa**
0	Price discounting early in the year raised cotton sales despite depressed market.	May '81	+27%	March	+29%	1.1200	−44%	Net foreign asset position has worsened sharply.	**Sudan**
0	Gov't aims to increase annual phosphate output to 6.8 mn. tons by 1986.	Dec.	+11%	March	+16%	1.8400	−10%	Saudi development fund to lend $51 mn. for water projects.	**Tunisia**
0	Tobacco earnings in 1982 down sharply owing to lower prices.	Sept.	+15%	Sept.	+ 8%	1.3600	− 4%	Foreign exchange availability extremely tight.	**Zimbabwe**
0	Budget projects 1982/83 oil revenues of $10.6 billion, 40% below fiscal '81/'82.	Dec. '80	+ 9%	April	+84%	3.4900	− 2%	Corporation set up to oversee official foreign investment.	**Kuwait**
0	Crude-oil exports holding steady.	n. a.	n. a.	Feb.	+27%	2.8935	0	Local banks lend $21 million for oil refinery project.	**Oman**
0	Oil output averaged 328,000 b/d Jan.-Apr., down 35% from same '81 period.	n. a.	n. a.	Sept.	+17%	.2748	− 1%	Money supply expanding steadily.	**Qatar**
0	Second quarter Aramco oil output estimated at 6.3 mbd, vs. 7.9 mbd in first.	Dec.	+ 2%	Sept.	+17%	.2940	0	Riyal devalued to 3.44 per dollar from 3.43.	**Saudi Arabia**
0	Exports of condensates from Sharjah to start in July.	n. a.	n. a.	March	+22%	.2740	0	Growth of credit to private sector slows.	**United Arab Emirates**

World Interest Rates

market rates as of July 14, 1982; bond yields as of July 9, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	16.50	12.187 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.00	5.50*	5.50
Day-to-Day Money	13.00 July 15	17.00	12.625	15.00	15.00	9.00	20.00	8.625	4.25* 1-month Euro-Swiss fr. rate	7.438
Treasury Bills 91-day, Middle Rates	11.97 discount basis	15.90	11.875	15.25	n. a.	n. a.	17.601 78 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	13.38 finance paper discount basis	16.65 finance paper 15% tax w/h	11.357	13.90 Certified	15.69 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.75	16.55 15% tax w/h	11.875	13.90 Certified	not traded	9.40	21.90	no market	5.063*	no market
Government Bonds Long-term, new and old issues, average yield	13.64	16.50	12.88	10.73 20% tax w/h	15.41	9.47	20.94	10.63	5.16†	8.20
Industrial Bonds prime, long-term, new and old issues, average yield	14.80 Aa Industrials	17.625	14.40	14.33	16.57	9.62	20.48	11.47	6.062†	6.73
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	18.25	18.25	17.50	16.60	12.00	21.75 ⅛ qtrly fee on outstdng.	10.50	9.00*	6.00
Bank Time Deposits 3-month	14.00 Cert. of Dep.	16.35	16.35	14.90	14.625	9.25	11.50	9.125 large deposits	5.25* residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	14.948	16.75	16.75	no market	15.688	9.063	no market	9.063	4.875*	7.438
Exchange Rates—in U.S.$ rates floating against the $	—	.7886	1.724	.0210	.1444	.4011	.000717	.3635	.4701	.00391
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.678 *D*	2.595 *P*	.285 *D*	.554 *D*	6.086 *P*	5.579 *D*	5.945 *P*	10.884 *P*	7.586 *P*

Eurodollar Deposits
(London, interbank, bid)
July 15

7-day	13.625
1-month	14.188
3-month	14.688
6-month	15.938

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.337
U.S.-Canada Treasury Bills	−1.436
U.S.-Canada Finance Co. Paper	−1.369
Eurodollars-U.K. Local Auth. Deposits	−0.158

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.375
Over 7 yrs.	15.625
DM Bonds	
7 yrs. and under	9.375
Over 7 yrs.	9.50

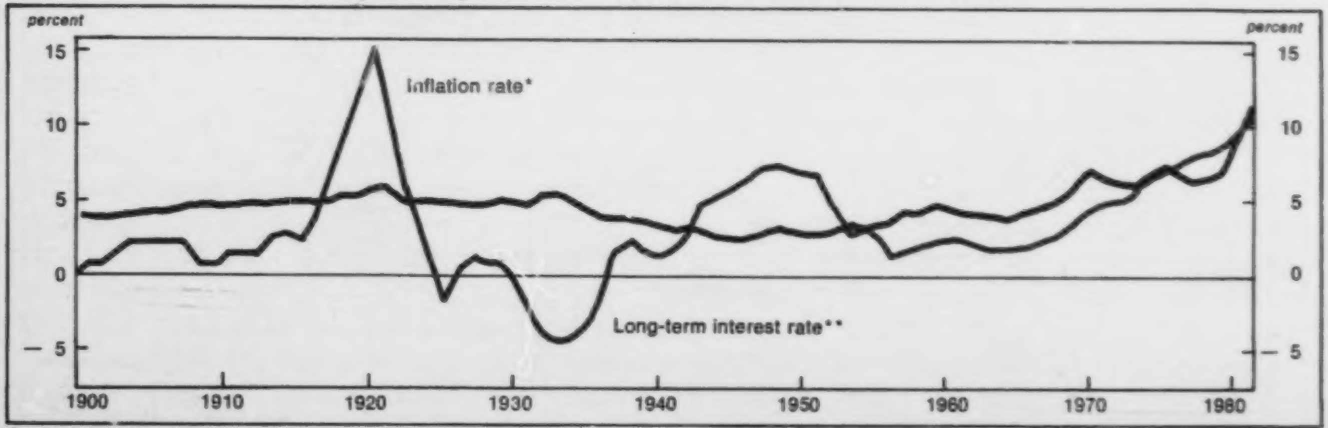
Gold Price

London afternoon fixing

352.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements. *Market rates as of July 7, 1982. †Bond yields as of July 2, 1982.

A history of U.S. interest rates and inflation



Data: U.S. Department of Commerce

* Five-year moving average of yearly percentage change in consumer price index.

** Average annual rate of high-grade municipal bonds.

The Inflation-Interest Rate Link Revisited

The question of why U.S. interest rates have not fallen as fast or as far as the inflation rate has confounded American politicians and perplexed economists, casting serious doubts over long-held theories of how inflation influences interest-rate movements. Businesses and consumers still rely heavily on the inflation outlook and its probable effect on interest rates in financial decision making. But the recent failure of disinflation to be translated immediately into lower rates has prompted a number of observers to dismiss this relationship as having limited significance. A review of how the two variables have interacted in the past, however, suggests that the current puzzle stems not so much from shortcomings of the underlying theory as from misunderstandings of how expectations of future inflation—a key element of the theory—are formulated and revised.

The traditional explanation of the link between interest rates and inflation can be traced to theoretical and empirical work done in the 1920s and 1930s by Irving Fisher, a leading American economist of that period. Fisher held that interest rates can be separated into two components: a "real"—or inflation-adjusted—rate of return on investment, and a premium that compensates investors for the expected change in the purchasing power of money invested. Proponents of this view maintain that the "real" component—determined by savings preferences, the marginal productivity of capital, and the long-run prospects for growth—is essentially stable over long periods of time. Therefore, Fisher's theory assigns the predominant role in explaining interest-rate movements to the second component: expected inflation.

Historical data on interest rates and inflation suggest the importance expectations played in Fisher's thinking. As the chart on page 6 illustrates, there was little apparent correlation between observed inflation and interest rates during the period in which he worked. Although inflation expectations have been the subject of intense investigation and debate since Fisher's time, disagreement persists as to how they are formed, how quickly they are revised, and how they can best be measured.

Some researchers have simplified Fisher's model to conclude that interest rates should, in fact, follow observed inflation rates. This modification, however, requires a particular specification of the way in which inflation expectations are formed—"adaptive expectation"—which assumes that the market's forecast of inflation is based on no more than the history of inflation itself. If this were the case, then inflation expectations would continuously lag actual changes in the price level and interest rates would follow movements in inflation—again assuming that the "real" component of rates is relatively stable.

The adaptive-expectations hypothesis obviously fails to explain the disjointed behavior of interest rates and inflation over much of the period covered by the chart. This approach suffers from a more fundamental shortcoming, however, in that it fails to take account of the efficiency of the financial markets in their use of other information that might indicate a change in the future course of inflation.

Monetary regimes

Historically, one of the principal influences on the market's formation and adjustment of inflation expectations has been the existing monetary regime. For example, in the years prior to 1933, U.S. monetary policy was, for the most part, subject to the discipline of a freely convertible gold standard. Under such a commodity standard, the money supply was not under the control of a government monetary authority that stood to benefit either from a gradual inflation or from the prevention of major price declines. Financial market participants were therefore likely to view price shocks as only temporary, without revising their longer-run expectations of future inflation. Periods of rising prices were bound to be followed by falling prices, and vice versa, as demand adjusted to a relatively fixed supply of money; borrowers and lenders saw little need to adjust interest rates for these accepted, self-correcting swings in the value of money. Hence, over this period there was no significant correlation between price changes and interest rates.

Interest rates subsequently seemed to move in a manner oblivious to the sharp price increase that followed the suspension of gold convertibility in 1933 and continued through the second world war. Government credit controls certainly played a part in impeding an adjustment of rates to the inflation outlook, but once again the expectations underlying that outlook were crucial. Market participants expected that the transition to a peacetime economy would be marked, as such transitions had been in the past, by a reversal of the steep wartime increases. Thus, a complete adjustment of rates to prevailing levels of inflation was seen as unnecessary. These expectations were not completely realized, however, as the world's industrial economies embarked on a new path of monetary management, heralded by the Bretton Woods agreement of 1944.

The postwar era has featured a succession of monetary regimes, with differing impacts on the formation of inflation expectations. The Bretton Woods system

The Inflation-Interest Rate Link Revisited

(continued from page 7)

was marked by an agreed-upon world reserve currency—the dollar—that was not only part of a worldwide fixed exchange rate system but was also convertible, for foreign holders, into gold at an official price. The U.S. monetary authorities—the Federal Reserve—faced severe constraints in their management of the money supply under what was essentially a worldwide gold standard. Inflation expectations were accordingly low over this period, until the first signs appeared in the mid-1960s of the Federal Reserve's attempt to evade the guidelines set forth in the agreement. When it became clear—from the restrictions on convertibility imposed in 1968—that the Bretton Woods system had little chance to survive, financial markets could no longer rely on the self-correcting mechanism of a commodity standard in forming their expectations of inflation. Consequently, a progressively larger share of each subsequent money-supply shock found its way into expectations of future price changes.

The disintegration of the Bretton Woods system was confirmed by the closing of the government's gold window in 1971 and the free floating of the major currencies in 1973. This left the Federal Reserve managing a purely fiat currency, with predictable consequences: The rapid money-supply expansion—unprecedented in the post-war period—was quickly incorporated into expected inflation, as there was little reason to believe that this expansionary policy would be reversed. This resulted in the closest correlation of observed inflation and interest rates in recent history.

Finally, for their impact on the formation of inflation expectations, the events of October 6, 1979, may be said to have ushered in a new monetary regime—the one still in effect today. The date marked a shift in the operating strategy of the Federal Reserve, committing it to a policy of direct control of the monetary aggregates. The new strategy has been implemented at the cost of unprecedented interest-rate volatility over the short run. This is because the new operating tactics, without necessarily affecting inflation expectations directly, have introduced a greater degree of uncertainty over the Fed's reaction to short-run changes in the supply and demand for money and credit.

Since this strategy was enacted, however, the Fed has also given notice to the financial markets that money growth significantly outside its targets will no longer be tolerated and should not be incorporated as a permanent shift in revised inflation expectations. Nevertheless, beyond this perceived strengthening of the Fed's resolve to slow the growth of the aggregate money supply, there still exist no constraints that guarantee such an outcome, other than the self-discipline of the monetay authorities themselves. Resolve and self-discipline in the past have proved to be a fragile basis for monetary policy. Consequently, every policy statement or action of the Fed has been subjected to close scrutiny. And although borrowers and lenders may have adjusted their inflation forecasts downward, they are highly uncertain of the accuracy of these forecasts.

The missing link: uncertainty

This element of uncertainty has suggested to some economists that Fisher's inflation expectations hypothesis, although useful as far as it goes, has overlooked a third component that may be vital in explaining the situation in which the financial markets currently find themselves. This third component is a measure of the uncertainty with which inflation expectations are held—based on the assumption that lenders must be compensated not only for the expected change in the value of their funds over the investment period, but also for the uncertainty with which they view those expectations. This uncertainty is directly related, along with the real and expected inflation components, to interest rates.

Thus, it would be a mistake to dismiss altogether the significance of inflation expectations in determining interest rates. Fisher's theory—with some updating—still provides a useful framework for analyzing the current behavior of interest rates relative to the outlook for inflation. Specifically, if financial decision-makers are confident that the market's expectation of inflation has been revised downward, then the failure of rates to follow focuses attention on the likely increase in uncertainty surrounding these revised expectations. It may well be that the Federal Reserve, having succeed in its aim of lowering current and expected inflation, now faces the difficult task of reducing the uncertainty clouding this new outlook.

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German Monetary Policy Likely to Ease

Recent developments in Germany and in the world economy suggest that another easing of German monetary policy will occur soon. Not only have inflationary pressures—both homemade and imported—subsided, but also the German economy is proving much weaker than had been anticipated only a few months ago.

Germany's domestic inflation problems were aided by the 1981-82 wage round, which brought pay rises of about 4%. These are now being reflected in a year-on-year growth rate of industrial unit labor costs of only 2.5%. Moreover, consumer price increases slowed in the first half of the year. Excluding the June number, which was raised by higher indirect taxes, the consumer price index rose at a seasonally adjusted annualized rate of only 3.6% during the first five months.

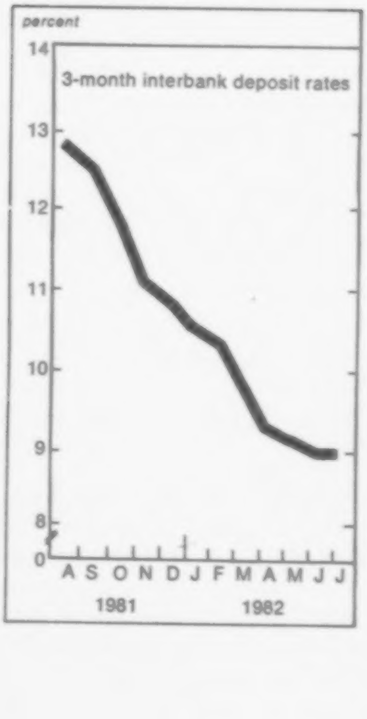
Imported inflation has fared even better. Import prices in terms of the mark actually declined in the first half of 1982 and, by June, were 0.4% below the level of June 1981—despite a 7.6% decline in the DM against the dollar between December and June. This improvement in the face of a strengthening dollar reflects primarily the fall in dollar-denominated commodity prices—down by some 18% in the twelve months to July—but also the revaluations of the DM within the European Monetary System.

Germany's real economy, however, has been disappointing. Real GNP declined slightly in the first quarter, and domestic industrial order volume continues to drift down. In addition, orders from abroad, which softened the recession last year, have fallen sharply over the past three months.

Over the course of 1981, the Bundesbank held interest rates higher than was justified by short-term growth considerations, ostensibly in order to finance Germany's current-account deficit but more fundamentally to dampen inflation by upholding or at least cushioning the DM exchange rate. The easing of dollar-denominated inflation, however, now substantially reduces the inflationary cost of a weaker DM against the dollar at a time when domestic inflationary pressures are also receding.

These trends, coupled with the recent declines in U.S. interest rates, suggest that a further fall in German interest rates is in the offing. Unfortunately, however, such a shift is not entirely riskless. Germany's targeted money stock, Central Bank Money, has been growing at the upper end of its 4%-7% target range. If lower interest rates result in faster money-supply growth, a shift in inflation expectations could ultimately result in a fall in German long-term bond prices.

German interest rates



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Worsening of inflation poses problems for Swiss franc.

Switzerland's rate of inflation has stepped up sharply since the end of the first quarter. The consumer price index advanced at an annual rate of 11.5% in the second quarter and in June stood 6.2% above its year-ago level. This represents a worsening relative to inflation in Germany–Switzerland's major trading partner. The deterioration in the Swiss inflation picture was due, in part, to the Swiss National's Bank's relaxation of monetary policy at the beginning of the year, which contributed to a weakening of the exchange rate and increased import costs. Since January, the Swiss franc has fallen 17% against the dollar and 6% against the mark. In addition, however, underlying cost pressures have remained a relative burden for the Swiss, as unit labor costs have risen by some 6% over the past year against less than 3% in Germany. Given added cyclical forces, pressure on the Swiss franc against the mark is expected to continue for the time being. But since Swiss monetary policy has now turned more cautious, these pressures are likely to be reflected in relative interest rates between the two countries.

Progress made toward improving long-term prospects for Belgian economy.

Despite indications that Belgium's recovery will be delayed until early 1983, considerable progress has been made toward correcting some of the country's more fundamental economic imbalances in the seven months since the December 1981 general elections. Last year, the country's current-account deficit exceeded 7.5% of GNP, the public sector deficit rose to 15.3% of GNP, and unemployment was rising rapidly. The new government obtained special powers to loosen wage indexation and to modify the tax and social security structure. The devaluation of the Belgian franc–together with subsequent realignments of the EMS and a stronger U.S. dollar–led to an estimated 10% devaluation in the effective exchange rate. Although this is likely to raise Belgium's inflation rate to an average of 10% this year, the relaxing of indexation ensures that real wages will fall by at least 4%, suggesting improvements in export competitiveness and in longer-term prospects for employment.

Escudo devaluation aims to provide boost to Portuguese exports.

Portugal's highly open economy has been hard hit by the current world slowdown. In 1981, with European demand for textiles weak, export receipts declined 11.2% in dollar terms. Furthermore, a severe drought added as much as 5% to the import bill because of increased purchases of food and fuel. This, combined with sluggish tourism and the adverse impact of high interest rates, resulted in a current-account deficit of $2.6 billion in 1981, some 11% of GDP, and more than double the 1980 gap of $1.25 billion. With export demand remaining depressed it is unlikely that the deficit will decline to substantially less than $2 billion in 1982. Meanwhile, Portuguese inflation returned to 25% in the spring, prompting the authorities to use the occasion of the June EMS realignment to devalue the escudo by 3.75% against the French franc while maintaining the 0.75% monthly crawling peg adjustment. This should improve Portuguese export competitiveness in advance of the long-awaited world recovery.

Colombian economic activity at a low but expected to pick up soon.

Colombia is currently experiencing a lull in economic activity. Unemployment, according to the latest available data, climbed to 9.7% in March, compared to a year-earlier level of 9.1%, largely because of declines in construction and business investment. The foreign trade sector has also been drifting. Up until mid-May exports were down 10% from a year ago. And with imports rising about 4%, international reserves fell to $4.2 billion in May from $4.7 billion (minus gold) at the end of 1981. The government has sought to offset these downward influences, however, through stimulative actions, including stepped-up deficit spending and increased financial liquidity for business. In addition, activity in the natural resources is on the rise. Domestic oil output has gone up 15% in the past two years and in 1981 a record number of exploratory wells were drilled. Also, the vast Cerro Matoso nickel project started production last month. These various production indicators suggest a real GDP advance of about 3% in 1982–below Colombia's potential but impressive compared to the depressed conditions in some of the other Latin American countries.

Further widening of current-account deficit projected for Pakistan.

Pakistan's balance of payments suffered a marked deterioration in the just-ended fiscal year 1981-82, owing to the combined effects of the depressed state of the world economy, a steep decline in cotton and rice prices, a sharp slowdown in the growth of workers' remittances, and an appreciation of the rupee arising from its link with the strong dollar. Exports dropped an estimated 12% from the previous year. And although imports showed only a slight increase, the current-account deficit widened to some $1.43 billion or 4.6% of GDP from $991 million or 3.5% of GDP in fiscal 1980-81. Reserves fell an estimated $159 million, in sharp contrast to the $310 million increase the previous year. The current year's balance-of-payments outlook depends largely on the timing of recovery in the world economy and in the commodity markets. However, even assuming some rebound in cotton prices and a boost to Pakistani exports of manufactured goods—arising from last January's devaluation and the subsequent rupee depreciation—the current-account deficit is projected to widen to perhaps $1.64 billion or 5.5% of GDP in fiscal 1982-83.

Australian government hopes to improve money-supply control with new debt procedures.

Concern over its inability to control the domestic money supply has prompted the Australian government to change the way it issues bonds. On June 25, the government announced that, soon, a predetermined quantity of bonds will be offered for sale at market prices, probably every two months. Under the current system, securities are continuously offered for sale to all buyers at predetermined rates. Because of the government's past reluctance to offer realistic yields, however, too few bonds have been sold. This has hampered attempts by the monetary authorities to keep money growth within bounds. They have exceeded their monetary targets in each of the last three years, and are in danger of doing so again this year. Consequently, forecasters are currently predicting 11% inflation for 1982 and the Australian dollar has fallen sharply against the U.S. dollar. Policymakers are hopeful the planned revisions in bond issuance procedures will improve monetary control and thus help to remedy these problems.

Unprecedented deficits for South Africa's current account.

A sharp fall in the average price of gold and a 13% jump in import payments resulted in a severe balance-of-payments deterioration for South Africa in 1981. The trade account registered a $7.5 billion swing into a $464 million deficit that was paralleled by a $7.9 billion reversal in the current account—from a $3.5 billion surplus in 1980 to a $4.4 billion deficit last year. In the first quarter of 1982, further declines in the price of gold and high merchandise import prices boosted the current-account deficit to $6.7 billion, at a seasonally adjusted annual rate. The current stagnation of the South African economy, however, should help mitigate the apparent deterioration in the balance of payments somewhat in the remainder of the year as import volume contracts. Nevertheless, assuming an average gold price of $330/oz for the year, the current-account deficit can be expected to fall near a range of $5.5-6.0 billion.

New tin pact heightens uncertainty over market outlook.

Last month's adoption of the Sixth International Tin Pact has increased the difficulty of predicting tin production and prices. Eight countries that signed the previous agreement have rejected this one, including the United States, the largest consumer, and Bolivia, the fourth largest producer. This lack of participation suggests that the market interventions and production restrictions called for by the International Tin Agreement (ITA) may be insufficient to defend the 6.9% increase in the new floor price to $5.62/lb.—especially considering the current excess supply. World production of tin in 1981 exeeded consumption by over 51,000 tons, pushing current world inventories to an estimated 240,000 tons —almost 150% of last year's consumption. And the glut is expected to continue. Tin demand has fallen sharply since 1978, not only because of the recessions in the industrial countries but also owing to an increase in the real price of tin that has prompted tinplate users to seek substitutes. In this environment, U.S. plans to dump 35,000 tons from its tin stockpile onto the world market by 1983 undoubtedly will have serious negative repercussions on future prices.

The U.S. Economy

Can Balancing the Budget Be Made Simple?

President Reagan has added his voice to the growing chorus calling for a constitutional amendment requiring a balanced federal budget. Against the backdrop of sky-high interest rates, the near-breakdown of the budget process, and the threat of a 50% increase in the public debt in four years, it is not surprising that 31 states have requested a constitutional convention to consider this issue. To avoid opening this possible Pandora's box, however, Congress is likely soon to submit to the states some form of a balanced budget amendment to demonstrate its own concern about the magnitude of the prospective deficits.

Regardless of unanswered questions about the theory that links budget deficits to high inflation and high interest rates, the desire for reducing these magnitudes is clearly behind the current drive for a balanced budget amendment. Lower levels of inflation and interest rates are necessary to create a climate conducive to more stable and sustainable economic growth by increasing capital spending, labor productivity, and economic efficiency.

In general, the proponents of a balanced budget amendment view public spending as a burden on the economy because government uses resources less efficiently than the private sector. To minimize the loss of efficiency from the growth in government spending, most favor including a provision that would limit the growth in receipts in any fiscal year to the rate of increase in national income in the prior calendar year. Coupled with the requirement that the budget be balanced, this provision effectively places a limit on the growth of expenditures.

There are two possible shortcomings to this attempt to limit spending, however. First, because no distinction is made between a change in real income and a change in income resulting solely from inflation, government would still benefit from inflation by receiving greater revenue. Second, the lag in calculating the allowable increase between the current fiscal year and the previous calendar year means that, on average, fiscal policy would be procyclical. This means that, because growth in nominal national income usually increases during an expansion, the allowable rate of increases in taxes and spending would still be rising as the economy peaked and entered a recession. But as income growth slowed or fell during the recession, spending would have to be cut or taxes raised, worsening the recession.

While it might be politically comforting to have a constitutional rule for fiscal policy that would promise to produce what existing congressional processes have failed to deliver, difficulties would inevitably arise from oversimplification. Attempts to design a balanced budget rule have elicited criticisms from all sides:

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1981		BALANCE O				
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use of credit, lions of
Austria	Mild recovery still expected this year; research institutes forecast 1983 growth at 2.5%-3%.	Jan.	+ 6%	65.8	0	May	4,647	+ 6%	2.7	
Belgium	Industrial production declined in first quarter; economy now not expected to recover before early 1983.	Feb.	0	96.1	+2%*	May	3,347	−51%	0.7	
Britain	Still few signs of sustained recovery in business conditions.	May	+ 4%	523.6*	−2%	May	13,436	−26%	1.5	17
Denmark	Industrial orders are still rising; business hoping for a good year.	March	0	64.7*	0 *	May	2,009	−23%	1.3	
Finland	Trough of current business cycle expected this year; little change in GDP likely.	April	− 1%	47.8	+1%	May	1,280	−18%	1.1	3
France	Austerity package, including wage-price freeze, worsens business prospects.	May	0	657.0*	+2%*	May	15,775	−47%	1.5	
Germany	Volume of foreign orders falls sharply, domestic orders slow; inflation set to decline.	May	0	689.4	0	May	42,471	−15%	3.1	
Ireland	Economic growth slowing in wake of tough measures imposed in recent government budgets.	Feb.	+ 2%	17.6*	+2%*	May	2,745	+19%	3.1	
Italy	Leading indicators turn down, increasing doubts about sustainability of recovery.	May	+ 2%	394.9*	+4%*	May	12,991	−19%	1.6	
Netherlands	General election to be held September 8; outgoing government proposes restrictive 1983 budget.	April	− 2%	167.4*	+1%*	May	8,796	− 6%	1.6	
Norway	Reduced offshore oil output will produce GDP decline but domestic activity will continue high.	April	+ 2%	55.6	+1%	May	7,261	+14%	5.2	
Portugal	Export weakness constraining growth.	Dec.	+ 3%	23.5*	+6%*	April	356	−25%	0.5	2
Spain	Inflation on a year-over-year basis up to 15.1% in May.	Dec.	− 1%	211.1*†	+1%*	April	9,303	−12%	3.5	8
Sweden	Economy set to grow in 1982, although May new orders were down 6% from year earlier.	April	− 4%	111.6	−1%	May	3,415	−17%	1.6	
Switzerland	Real GDP flat in first quarter compared with year earlier.	Dec.	+ 2%	97.8	+4%*	May	13,022	+25%	5.0	
Turkey	New chief economic policymaker will shortly publish economic program for next twelve months.	n. a.	n. a.	60.0	+4%	May	1,272	+41%	1.7	1,43
Canada	Business and consumer confidence at low levels as economy slows and inflation stays high.	May	−11%	274.0	+3%	June	2,148	−11%	0.4	
United States	Hopes for imminent recovery remain high although few concrete signs have yet appeared.	June	−10%	2,925.5	+2%	May	19,765	+ 8%	0.9	

†GDP *1980

It would be too binding, too difficult to implement, or too easy to override or circumvent.

One of the sharpest criticisms of the proposal is that it does not give policymakers sufficient discretion. Opponents argue that to require spending cuts and tax increases by law for the sake of a balanced budget during an economic downturn—when falling incomes act to reduce receipts and increase expenditures—would run the risk of worsening the recession. This policy could lead to a vicious cycle of deficit-widening and deficit-closing at the expense of the economy.

Critics further argue that implementation difficulties would arise because of long lead times in the budgetary process. By law, the President submits his budget proposals in late January or early February for a fiscal year that ends about 20 months later. By then, a changed economic environment could wreak havoc on a budget plan. As an example, in early 1980 the Carter administration submitted its budget proposals for fiscal 1981 showing a deficit of $16 billion. By the end of the fiscal year, however, the deficit had ballooned up to $58 billion—chiefly because of a worse-than-forecast recession.

A third criticism of the balanced budget amendment is that any version likely to pass Congress would probably be fairly easily overridden or circumvented. Congress would not want to place itself in such a fiscal straitjacket that a super majority could not escape, and suspension during times of war is taken for granted. Moreover, Congress could—as it has in the past—shuffle agencies between on-budget and off-budget status depending upon whether they were in surplus or deficit.

The most popular version of the balanced budget/receipts limitation amendment currently before Congress fails to overcome significantly any of the obstacles mentioned above. In addition, it calls for Congress to enact a balanced budget every year unless 60% of each chamber specifically votes in favor of a deficit, or in the event of war. Suspension of the receipts limitation requires only a simple majority vote or a declaration of war. The ease of this escape provision substantially dilutes the likely effectiveness of the proposed amendment in slowing the growth in government spending.

Even if a balanced budget amendment were to be ratified, however, Congress would still be subject to pressures from special interest groups to increase spending. And it is the level of spending that determines the burden of government on the economy, since it ultimately has to be financed by taxes in the present, bonds (future taxes), or money creation (inflation or hidden taxes). The intent of a constitutional fiscal policy rule is to make it easier for Congress to say "no" to spending requests because of the knowledge that other expenditures would have to be reduced or taxes raised. But no constitutional rule can eliminate the difficult decisions that will have to be made if the ultimate goals of sustainable economic growth and lower inflation and interest rates are to be achieved.

Douglas L. Bendt

AYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				central bank rate△	exchange rate in U.S. dollars July 28, 1982	current monetary conditions	
IF il- lars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)				
	Current account improved relative to 1981, but outlook now less favorable.	May	+ 6%	April	— 2%	6.75%	.0581	Interest rates set to ease.	**Austria**
	Poor short-term outlook for rest of Europe reduces export prospects.	May	+ 9%	Dec.	+ 2%	14.00%	.0213	EMS adjustment has temporarily relieved pressure on franc.	**Belgium**
	Current-account surplus to date is well below 1981, but still substantial.	June	+ 9%	April	+11%	12.06%	1.7350	Bank of England actively forcing interest rates down.	**Britain**
	June devaluation expected to reverse deterioration of trade balance.	March	+11%	Jan.	+14%	11.00%	.1167	Interest rates have eased slightly since June devaluation.	**Denmark**
	Jan.-June showed fmk. 1.6 bn. current-acct. surplus vs. fmk. 774 mn. year ago.	May	+10%	Feb.	+19%	8.50%	.2105	Monetary conditions have been eased slightly this year.	**Finland**
	Current-account deficit FF 12.2 billion in first quarter.	June	+14%	Jan.	+16%	9.50%	.1460	Short-term rates sharply reduced following Franc devaluation.	**France**
	Terms of trade improving to offset unfavorable export outlook.	June	+ 6%	April	+ 3%	7.50%	.4049	Interest rates expected to decline.	**Germany**
	Current account expected to improve later in 1982.	Feb.	+19%	April	+ 4%	18.50%	1.4065	Banks see little prospect of early interest-rate fall.	**Ireland**
	Trade and current-account deficits improving after poor Feb. performance.	June	+15%	Feb.	+ 8%	19.00%	.000728	Money continues tight.	**Italy**
	Current account continues in substantial surplus.	May	+ 6%	March	+ 5%	8.00%	.3656	Interest rates expected to continue tracking German rates.	**Netherlands**
	Despite June deficit, 1982 first half still shows kr. 7.38 million trade surplus.	May	+11%	Feb.	+ 9%	9.00%	.1548	Monetary policy remains restrictive.	**Norway**
	Escudo devaluation should help export competitiveness.	March	+27%	Dec.	+ 9%	18.00%	.0118	Success of recent monetary tightness not yet evident.	**Portugal**
	Current-account deficit held to $1.4 bn. in first quarter vs. $2.4 bn. in 1981.	March	+14%	Feb.	+14%	8.00%	.00897	M3 accelerating; April year-on-year growth was 16.8%.	**Spain**
	Balance of payments expected to widen slightly from 1981's kr. 15 billion.	May	+ 9%	March	+ 9%	10.00%	.1629	Riksbank increased cost of funds to commercial banks.	**Sweden**
	First half 1982 trade deficit sf 2.3 bn. versus sf 3.8 bn. year ago.	June	+ 6%	March	+12%	5.50%	.4819	Money growth picks-up in line with easier policy.	**Switzerland**
	Jan.-May trade deficit fell to $1.37 billion from $2.98 billion year earlier.	April	+37%	n. a.	n. a.	31.50%	.0060	Securities-firm collapse leaves financial market in turmoil.	**Turkey**
	Reserves supported by drawings from commerical banks.	June	+11%	June	+ 3%	15.60%	.7917	Interest rates decline slightly.	**Canada**
	Large monthly fluctuations in trade deficit continue; June deficit was $3.4 bn.	June	+ 7%	June	+ 1%	11.50%	—	Interest rates falling sharply as Fed eases.	**United States**

△most recently reported

World Interest Rates

market rates as of July 28, 1982; bond yields as of July 23, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	11.50	15.60	12.0625 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.00	5.50	5.50
Day-to-Day Money	11.75 July 29	18.50	12.875	14.00	15.00	9.05	20.00	8.625	6.25 1-month Euro-Swiss fr. rate	7.25
Treasury Bills 91-day, Middle Rates	10.66 discount basis	15.20	11.25	14.75	n. a.	n. a.	17.609 92 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	12.00 finance paper discount basis	15.60 finance paper 15% tax w/h	11.012	13.90 Certified	14.75 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	11.70	15.55 15% tax w/h	11.3125	13.90 Certified	not traded	9.40	21.60	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	13.31	16.05	12.53	10.47 20% tax w/h	15.33	9.25	20.80	10.35	4.89	8.092
Industrial Bonds prime, long-term, new and old issues, average yield	15.00 Aa Industrials	17.25	13.96	14.405	16.46	9.35	20.38	11.44	5.69	6.60
Bank Short-Term Rate to Best Borrowers (prime rate)	15.50 July 29	17.25	13.00	17.50	16.60	12.00	21.75 ⅛ qtrly fee on outstdng.	10.50	9.00	6.00
Bank Time Deposits 3-month	11.625 Cert. of Dep.	15.55	11.8125	14.35	14.75	9.10	11.50	8.875 large deposits	3.50 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	13.375	16.1875	12.125	no market	16.375	9.0625	no market	9.125	4.500	7.1875
Exchange Rates—in U.S.$ rates floating against the $	—	.7917	1.7350	.0213	.1460	.4049	.000728	.3656	.4819	.0039
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.625 *D*	1.25 *P*	1.00 *D*	3.00 *D*	4.125 *P*	7.50 *D*	4.00 *P*	8.00 *P*	6.25 *P*

Eurodollar Deposits

(London, interbank, bid)
July 29

7-day	11.75
1-month	12.25
3-month	13.25
6-month	14.25

International Arbitrage

(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.686
U.S.-Canada Treasury Bills	−1.159
U.S.-Canada Finance Co. Paper	−0.761
Eurodollars-U.K. Local Auth. Deposits	+0.250

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.50
Over 7 yrs.	15.25
DM Bonds	
7 yrs. and under	9.375
Over 7 yrs.	9.25

Gold Price

London
afternoon fixing

347.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(June) 7.1	(June) 11.2	(June) 9.2	(June) 13.6	(June) 5.8	(June) 16.2	(June) 6.2	(May) 2.3
Industrial production*	(June) −9.5	(May) −11.3	(May) 3.7	(May) 0	(May) 0	(May) 2.0	(Dec.) 2.0	(May) 1.4
Trade balance† *(billions of local currency units)*	(June) −$3.44	(May) C$1.36	(May) −£0.12	(June) −FF11.78	(June) DM4.77	(May) −Lit.1,910	(June) −SF0.34	(May) ¥307.5
Money supply (M1)*	(June) 1.1	(June 2.6	(April) 10.9	(Jan.) 16.0	(April) 2.5	(Feb.) 8.3	(March) 12.0	(March) 7.3
Velocity of money (M1)*	(March) −0.4	(Dec.) 17.7	(Dec.) −5.9	(Sept.) −3.6**	(Dec.) 7.1	(Dec.) 7.3	n. a.	(Dec.) −5.2
Reserves minus gold *($ million, change from previous month)*	(May) −630	(June) 78	(May) −414	(May) −1,538	(May) 531	(May) 103	(May) 569	(May) −264

* Percent change from 12 months earlier.

**based on GDP

† Figures are only for the month indicated.

The Transatlantic Breach

"The problem is that every country is tempted unilaterally to change the trading rules, and broaden the exceptions, as a way to deal with economic crisis. In short, each nation wants the long-term benefits of being part of the international trading system, but at the same time wants the luxury and license to change the rules whenever necessary and pursue its national interest in its own way without regard to consequences for others."

Those words were spoken by U.S. Trade Representative William Brock in February. That was before the steel and pipeline disputes drove a wedge between America and the European Economic Community (EEC). And it was before senior European officials—including British Prime Minister Margaret Thatcher—publicly accused the United States of acting in the very manner alluded to by Brock. But it would be misleading to dismiss this latest trade clash as just another routine conflict. Rather, it reflects a marked widening of the philosophical gulf that separates Europe and America in the economic and political arenas.

On both sides of the Atlantic, there has been an unsettling shift away from accommodation and toward confrontation. An outright trade war is unlikely, since both sides realize the cost would be far too high. But if trade tensions are not defused—and quickly—the long-awaited world economic recovery may be delayed and weakened. Moreover, other areas of potential U.S.-EEC cooperation – including proposals that will come up at the November trade ministers' meeting of the General Agreement on Tariffs and Trade (GATT) – may be jeopardized. This little-publicized but critical session of the international trade watchdog in Geneva could be instrumental in warding off protectionist pressures, a vital task if the international economic system is to be preserved. Economists have long argued that trade barriers misallocate resources and lead to a cycle of declining real earnings, reduced saving and capital formation, slower economic growth, and higher prices.

Steel duties and the pipeline embargo

The most recent deterioration in transatlantic relations was touched off in June when the Commerce Department tentatively determined that EEC steelmakers, aided by government subsidies, were undercutting U.S. steel companies. That paved the way for hefty countervailing duties—ranging up to 40%—which for some leading European companies would be tantamount to banishment. Europe's pique was then compounded by the unexpected U.S. decision to broaden the restrictions on the export of technology for the planned Soviet-European natural gas pipeline, to include U.S. corporations' foreign subsidiaries and European companies manufacturing under U.S. license. Now the EEC is hinting at retaliation.

From the U.S. point of view, these were two isolated moves: The steel duties resulted from legal proceedings that left government officials little flexibility, while the extended pipeline sanctions reflected the President's desire to put pressure on the Kremlin over Poland. But across the Atlantic, the actions were viewed quite differently. Americans appeared headed down the road of economic nationalism, still lacking a coherent foreign economic policy. In the case of steel, Europe accused the United States of unilaterally—and incorrectly—interpreting the new GATT subsidies code. According to the EEC, America has failed to distinguish between grants used for restructuring and those used for current operating expenses. The EEC also fears that, ironically, the offsetting duties could undermine its program to phase out steel subsidies by 1985. And the EEC interpreted the U.S. pipeline decision as an attempt to exercise "extraterritorial" political control, besides raising questions about America's reliability as a supplier.

European leaders are counting on the pipeline to reduce energy dependence on the Middle East, to bolster trade, and to create jobs. The OECD forecasts that European unemployment will rise to 10.5% next year from the current post-war high of 9.75%. And this comes at a time when only an anemic world recovery is expected, industrialized nations are having trouble adjusting to growing competition from the newly industrialized nations, and world trade is limp. In 1981, the value of trade declined for the first time since 1958, and the volume, after having risen by only 1% in 1980, stagnated. In Europe's view, things would not be quite so grim if U.S. policies had not driven interest rates sky-high and if the dollar had not been abandoned to soar.

But U.S. officials are not about to take the blame for Europe's economic woes, especially at a time when U.S. unemployment is up to 9.5%, farm incomes are quite low, and some recession-struck industries, such as steel, are running at severely depressed capacity levels. For years, the United States has complained that government handouts—not only in industry but in agriculture—have given European exporters an unfair competitive edge both here and in other non-EEC markets. Now, the Reagan administration seems determined to convince Europe that in an integrated world economy, government intervention in one nation necessarily affects other nations. In America, there is a tendency to offer protectionist assistance to industries thought to be of strategic economic importance, or to those that employ large numbers of workers; but handouts are frowned upon. Subsidies tend to distort income distribution and economic efficiency, much as tariffs and quotas do. European leaders, however, are much more sensitive to electoral pressures to subsidize strategic industries in competitive difficulties. Even the Germans, who regularly chastise their fellow EEC members for handouts, are becoming more interventionist—as shown by recent aid for troubled industrial giants.

Given this rather deep philosophical divide, how can trade tensions be defused? In the steel dispute, the two sides may yet reach an accord on volume or price, but time is short. As for the pipeline, the United States could forgo trying to enforce the sanctions. Or Europe could toughen its East-West stance, enabling the Reagan team, as part of its current foreign economic policy review, to bend a little.

The November GATT meeting

Even if these disputes are settled, however, other trade conflicts undoubtedly will surface. That is why Brock has poured so much energy into promoting the November GATT session—the first annual meeting to be held at the ministerial level in nine years. For the 87 member nations, it is a valuable political chance for reaffirming their commitment to resist shortsighted protectionist pressures and to observe the rules of the GATT. Underlying the multilateral treaty is the principle that trade privileges offered to one country should be extended unconditionally to all nations. For years, however, the GATT has been weakened as nations have ignored and undermined its rules. Major areas of trade—steel, shipbuilding, automobiles, and agriculture – now fall under special arrangements, such as "voluntary" restraint agreements, that circumvent the GATT. The challenge, then, is how to strengthen the GATT.

The United States is taking the most activist and optimistic approach by pushing for the GATT to embrace new areas—such as trade in services, capital movements, high technology, and trade-related investments. Otherwise, U.S. trade policymakers warn, nations will increasingly resort to bilateralism. So far, the administration has managed to water down a congressional "reciprocity" bill—aimed at Japan—that would have allowed America to retaliate against nations that did not give U.S. goods and services substantially equivalent market access. But other bills are in the works, even though, as the GATT has pointed out, trade and payments imbalances between any two countries are not a problem in a multilateral trading system with convertible currencies. Nor is bilateral reciprocity a problem in a trading system based on a pledge of unconditional most-favored-nation treatment.

America also insists that the GATT at long last attack the most heavily protected area of trade: agriculture. Here it enjoys strong support from Australia and New Zealand, which have questioned the value of membership if the GATT fails to tackle their overriding trade concern. And America is adamant about overhauling the "safeguard" provisions for coping with a sudden flood of goods that threaten serious injury to domestic producers. U.S. suggestions include improving notification procedures and bringing the various bilateral pacts and inter-industry cartels into the GATT framework so that these arrangements can at least be internationally policed.

But for the United States to push through such an ambitious action program for the 1980s, it will need the EEC's support. The EEC, however, has indicated that its qualified backing might be withdrawn if the steel and pipeline disputes are still unsettled. Even if tensions are defused by then, Europe worries that the GATT will be hard put just to hold the trading system together, and that these new initiatives pose as many snares and pitfalls as they do opportunities. The EEC is also reluctant to let the GATT touch its political hot potato: export subsidies and price supports for agricultural products.

As for the less-developed nations (LDCs), they are pressing in the GATT for greater access to markets and for security of that access. For years, the LDCs have questioned the GATT's relevance. Now, in light of the world economic malaise, they are seeking ways to strengthen it. But they have not expressed enthusiasm about the U.S. push to break new ground. The LDCs are suffering from sluggish export demand, depressed raw-material export prices, mounting foreign debt, and growing protectionist pressures. Should these pressures intensify because of U.S.-EEC-Japan sniping, the LDCs might get caught in the crossfire.

In sum, November could be a turning point for the GATT. With tensions between the major trading partners perhaps the worst in its 35-year history, members have a chance to make the agency more than just a forum for consultation, negotiation, and public pressure. A successful meeting could spell a possible turning of the tide against creeping protectionism and continued stagnation in trade and could provide an improved environment for a world economic recovery. On the other hand, failure—or agreement on nothing more than a meaningless trade pledge and an action program devoid of substance—could signal a further weakening of the trading system and business confidence. It is encouraging that the member nations have turned to the GATT for help. But they will have to rise far enough above their parochial interests to make a difference.

Laura K. Wallace

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Behind the Troubled Australian Dollar

The Australian dollar has continued to slip against the major currencies, and last month fell below parity with the U.S. dollar. Parity carries no special economic significance, of course. But the sinking through the parity threshold does have a certain psychological significance that draws attention to some of the underlying problems of the Australian economy.

Not long ago it was widely accepted that Australia enjoyed highly favorable economic prospects for the 1980s. Well-endowed by nature, the country was experiencing a resource-based boom. Given its dependence on foreign trade, however, it was inevitable that Australia eventually would feel the international recession. Non-farm GDP has been declining and unemployment is approaching 7%—quite high by Australian standards.

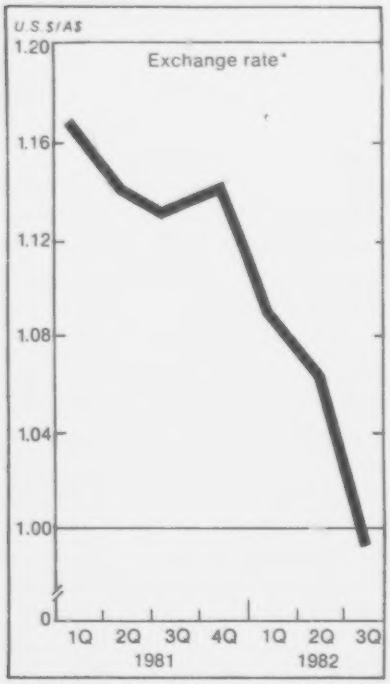
At the root of Australia's problems is the world's changing inflation environment. Over the past decade, as inflation accelerated worldwide, investors sought refuge in tangible assets. As a consequence, resource prices rose even faster than the general price level, and as the owner of vast mineral deposits, Australia was a beneficiary of this process. However, tighter monetary policies and the tempering of inflation expectations elsewhere have resulted in a relative shift in asset preferences away from real wealth. Current and expected future resource prices have collapsed, leading to the cancellation or postponement of a number of Australian investment proposals.

In addition, Australia's rate of inflation has remained stubbornly high, compared with the inflation rates of its major trading partners, and shows no signs of coming down soon. While inflation for the United States and for Japan is forecast to fall in 1982 to annual rates of less than 6% and 3%, respectively, Australian inflation is expected to be about 10.5%.

As elsewhere, inflation "down under" is a monetary phenomenon. But the reasons for Australia's monetary excesses are predominantly political. By accommodating the high wage settlements advanced by Australia's strong and militant labor unions, the monetary authorities have exceeded their monetary targets in each of the past four years.

Australia is now facing an unpleasant choice. To avoid chronic Australian dollar weakness, it must accept the unpalatable side effects of disinflation. The U.S. solution—tight money—would control inflation and ultimately, as unemployment rose, would moderate union demands. Britain's experience shows, however, that with militant labor unions the adjustment process is long and painful. Such a policy would require patience from the Australian people and tenacity from their political leaders.

The value of the Australian dollar



* Weekly average of daily figures at mid-quarter.

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Latin America: devaluations proliferate.

Foreign-exchange devaluations have speeded up in Latin America during the past two weeks. On the evening of August 5, *Mexico* devalued the peso once again and set up a two-tier—official and floating-rate—system. As of last Wednesday, the floating peso was trading at 75-82 pesos per U.S. dollar—a depreciation of roughly two-thirds from the rate before the February devaluation. Almost coincident with the Mexican devaluation, *Chile* allowed its peso to float, with the rate reaching around 59 to the dollar last Wednesday. Compared with the three-year fixed rate of 39 pesos that Chile had maintained since 1979, the peso has now lost about one-third of its U.S. dollar value. These latest moves represent significant shifts in the foreign-exchange rate systems of Mexico and Chile. They followed equally large exchange-system changes initiated in *Argentina* last month, toward a multiple-rate and floating regime. The exchange movements in these three key countries underscores what is becoming more evident for most of Latin America—that in circumstances of significant uncertainties in monetary policy and world economic activity, maintenance of fixed or pre-announced exchange-rate systems can be the prelude to losses of confidence and to capital flight.

Denmark's recovery may be accompanied by payments problems, rekindled inflation.

The Danish economy continues to show signs of recovery, and the Nordic countries' industrial federations have just issued a report projecting a 2.5% rise in Denmark's real output this year and 3% in 1983. The EMS realignments provided some stimulus: The kroner was devalued by a general 3% in February and then taken down by a further 4.25% against the DM in June, giving a boost to export competitiveness. The government now expects that unemployment will fall from its current rate of 9.5% to about 8% by the end of 1983. This improvement, however, will not be without cost. Despite the devaluations, the 1982 balance-of-payments deficit is likely to exceed last year's $1.7-billion figure, and 1983 is expected to bring only marginal improvement. In addition, wholesale prices have begun to rise again. And consumer prices are expected to post a 9.5% increase this year, on the heels of an 11.7% rise in 1981.

Dismal fish catch takes Icelandic economy to the depths.

Iceland's National Economic Institute has just produced one of its gloomiest forecasts ever. The main reason is a drastically reduced catch of cod and capelin. Fisheries production—which accounts for a large part of Iceland's GDP—is expected to be down between 12% and 20% in 1982 compared with last year. To make matters worse, the aluminum and ferro silicon industries have been hit by the depressed level of world economic activity. As a result, GNP is now expected to decline by at least 3% during the current year. Moreover, falling Icelandic export earnings are likely to take the current-account deficit to some 8% of GNP, compared with 5% in 1981. This comes as something of a setback for the small Icelandic population, but hope remains that the poor performance is only cyclical and that 1983 will see an improvement.

Norwegian trade deficit expected to be short-lived.

As expected, Norway's balance of trade swung into deficit in June—the first deficit since 1979. The trade gap reflects not only the reduced prices of oil exports, but also the weakening volumes of non-oil exports that have resulted from continued cost pressures in the domestic labor market. Overall, domestic inflation has been running at about 8.5% this year. At the same time, however, the kroner has remained strong on the foreign-exchange markets, so the competitiveness of Norwegian exports has been reduced. Part of the reason for the kroner strength has been the 25% weight given to the dollar in the basket of currencies used by the central bank of Norway in its stabilizing actions. Effective August 2, however, the central bank reduced the dollar weight to 11%. As a result, the kroner has since depreciated by about 2% against most currencies. Despite the June trade deficit, a balance-of-payments surplus of some $800 million is expected this year, rising to some $1.5 billion in 1983. Inflation is expected to continue to moderate. And economic growth, which has faltered in recent months, is forecast to pick up later this year.

Honduran economy hard hit by Central American political tensions.

Honduras is suffering from the spillover of widespread political tension in its neighboring Central American countries. Trade flows and tourism have been stifled, both local and foreign investor confidence has been badly shaken, and substantial capital flight has occurred. In addition, prices for Honduras' principal exports have remained soft in the face of high international interest rates and petroleum prices. As a result, the country's international payments situation has steadily worsened, and real GDP in 1981 posted virtually no growth following an increase of only 2.6% in 1980. Barring an improvement in the political situation in the rest of Central America, Honduras' economic activity is expected to decline still further. Discussions are currently under way for a new standby loan from the IMF and for rescheduling a major portion of the $270-million public debt owed to foreign commercial banks. This, as well as the level of multilateral and bilateral financial assistance and the extent to which the acceleration of capital flight can be contained, will determine whether further international payments deterioration can be prevented.

Thai trade gap down sharply owing to devaluation, domestic slowdown.

Thailand's trade deficit fell sharply in the first six months of 1982 to $595 million—down from $1.42 billion for the comparable period a year earlier. Despite the continuation of depressed prices for rice, rubber, tin, and other Thai commodities, exports rose over 17%, with some boost to manufactured goods undoubtedly provided by last year's devaluation. Another major contributor to the dramatic narrowing of the trade gap, however, was a 5% drop in imports that stemmed both from the devaluation and from a slowdown in the domestic economy. The central bank now projects that the trade deficit for 1982 as a whole will shrink at least to $2.1 billion from $3 billion in 1981, even if imports pick up considerably in the second half of the year. And in view of the slower domestic activity, the central bank has pared its estimate of 1982 real economic growth to 5.7%, substantially lower than the 7.6% growth realized in 1981.

The New Zealand budget: few unanticipated changes in economic policy.

The New Zealand government's fiscal 1982/83 budget—finally released on August 5—contained few surprises. New Zealand is currently experiencing 17% inflation, and real GDP is expected to grow by only 1% this fiscal year. After Prime Minister Muldoon responded to these problems with the imposition of a one-year wage and price freeze on June 22, the budget announcement had been widely anticipated as a barometer of future economic policy. The document indicates few unexpected changes. As promised, Muldoon reduced income taxes substantially. However, duties on luxuries, such as alcohol and tobacco, and on fuel will be increased. The government forecasts that overall receipts will rise by 16%. At the same time, expenditures are expected to go up by 14%, leaving the projected deficit equal to 5.9% of GDP—down from 6.4% in fiscal 1981/82. There is little in the new budget to encourage those who had hoped for a reduction in New Zealand's high tariffs. Furthermore, Muldoon's recent comments suggest that some of the wage and price controls may be continued beyond next June.

Oil glut pushing Algerian current account into deficit.

Algeria, as a producer of high quality "sweet" crude oil, has inevitably been affected by the current oil glut. But the adverse impact, to date, has been less than other producing nations have suffered. Oil output last year fell to an average of 800,000 bd from 1 million bd in 1980. Nevertheless, hydrocarbon revenues are estimated to have increased slightly in 1981 because of higher exports of condensate, LNG, and LPG. The early months of 1982 have been more difficult, with oil production reportedly down to about 600,000 bd. However, an advantageous deal was struck in March with the French government: premium prices for Algerian LNG exports in exchange for a commitment to award $2 billion in contracts to French companies. Still, gas exports remain uncertain. In particular, negotiations are under way with Italy over the price of natural gas to be delivered through the now-completed Trans-Med Pipeline. Consequently, Algeria's current account—after recording modest surpluses in both 1980 and 1981—is expected to move back into a deficit of about $1.5 billion in 1982.

Consumers Hold Key to Economic Recovery

Despite the turnaround in real GNP in the second quarter, there is considerable evidence that many sectors of the economy are still extremely weak. Latest data indicate that business investment is still declining and that inventories are still being liquidated. Factory orders fell in June, and industrial production is almost certain to have registered another drop in July. Given the level of interest rates, the strength of the dollar, and deficit worries in Washington, neither housing, exports, nor government is likely to lead a recovery. And it seems unlikely that consumer spending will rise enough to boost real growth to the nearly 4% annual rate now forecast by a consensus of economists for the remainder of 1982.

Recent evidence on the consumer sector is not encouraging. Retail sales rose by only 1% in July, despite a 2% increase in disposable income from the personal income tax cut and the cost-of-living adjustment to Social Security checks. Furthermore, this modest rise in sales followed a huge 3.3% decline in June. Continued increases in unemployment, still-high interest rates, and cautious consumer attitudes toward the use of credit are chiefly responsible for the relatively meager sales increase compared with the rise in income. There may be some carry-over retail sales gains in August and September, especially from salaried workers who only received the cut in taxes in their end-of-month paychecks. But this time around, any significant increases in consumer spending are likely to be short-lived.

Worries over the outlook for fiscal policy may also be contributing to consumers' reluctance to spend. Congress is currently considering a tax bill that would raise individual taxes nearly $10 billion in fiscal 1983, taking back about one-fourth of the recent gain in disposable income. Moreover, some recent congressional estimates now place the deficit at about $150 billion for the next several years. Individuals may reason that such large deficits will place upward pressure on interest rates, keeping many sectors of the economy depressed and leading to increased precautionary saving. Furthermore, if the public's expectations about future deficits have also been revised upwards, then consumers may increase their savings to pay the higher expected future tax liabilities arising from the interest on the additional debt.

Both the Federal Reserve and the Reagan administration have contended that current fiscal and monetary policies will foster a moderate, consumer-led recovery. But policymakers are also counting on consumers to increase savings, in order to fund higher investment and rising government deficits. Unfortunately, consumers cannot take the lead in both directions simultaneously.

Douglas L. Bendt

Asia and Oceania

Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE				
			6 months ending	12-month change	in billions of dollars	$ per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	u c lion
Asia	**Bangladesh**	Budget for fiscal 1982-83 imposes new taxes and raises petroleum and other prices sharply.	March	− 4%	11.6*	126	June	105	− 55%	0.5	
	Burma	Growth targeted at 6% for FY 1982-83 but could be lower.	Jan.	− 3%	5.3*	146	June	155	− 47%	5.8	
	China, People's Republic	Strong domestic growth forecast owing to recovery in heavy industry and good harvest prospects.	June	+10%	260.0	260	April	6,077	+136%	3.3	
	Hong Kong	Financial Secretary Bremridge lowers forecasts for fiscal year: real GDP growth 6%, inflation 11%.	Nov.	+23%	24.3	4,710	n. a.	—	—	—	
	India	Aid consortium pledged $3.66 billion in new commitments for fiscal 1982-83.	March	−17%	161.4*	236	March	4,461	− 35%	4.1	1.
	Indonesia	Declining revenues force a slowdown in government spending.	Dec.	+ 3%	77.5	500	March	5,235	− 15%	4.5	
	Japan	Fiscal stimulus package to be considered in September.	May	− 2%	1,129.6	9,684	June	25,431	− 7%	2.1	
	Korea	Curb market scandal does not mar outlook; slow steady recovery.	May	+ 6%	63.4	1,638	June	2,556	+ 5%	1.2	1.
	Malaysia	Government pledges 14% cut in 1982 expenditures, lowers real growth forecast to 5%.	March	− 9%	23.6	1,638	April	3,647	− 9%	3.7	
	Pakistan	Budget for fiscal 1982-83 imposes 5% import surcharge, 5% tax on domestic oil production.	April	−29%	31.2*	364	June	809	− 24%	1.9	
	Philippines	Government announces subsidy for hard-hit copper producers.	Dec.	−10%	38.6	780	June	2,002	− 12%	2.8	
	Singapore	Tight labor market means wages will rise faster than 4%-5% inflation.	May	+ 4%	11.6	4,780	March	7,360	+ 8%	3.0	
	Sri Lanka	Real growth could slow to around 4% in 1982 because of drought.	Jan.	0	4.4	291	June	234	+ 6%	1.8	
	Taiwan	Wages flat and unemployment increasing.	Dec.	+17%	45.5	2,530	Jan.	7,683	+219%	4.7	
	Thailand	Government pares 1982 growth estimate further to 5.7%.	March	+ 5%	36.1	750	June	1,514	+ 6%	2.0	
Oceania	**Australia**	Rising unemployment foreshadows less labor militancy; inflation still a problem.	June	− 2%	156.0	10,500	May	3,895	+ 36%	1.8	
	New Zealand	Wage-price freeze may hide inflation, but will not eliminate it.	April	− 4%	24.4*	7,858	June	339	− 3%	0.7	
	Papua New Guinea	Government practices austerity; public spending to fall 3% this year in real terms.	Dec.	−15%	2.6**	838	June	257	− 11%	n. a.	

*Fiscal year **1980

Upgrading Corporate Balance Sheets

The recent decline in bond yields has prompted many firms to take steps to improve their balance sheets, either through the lengthening of maturity structures or through the reduction of overall debt ratios. The market's continued uncertainty over whether the bond rally will be sustainable, however, has spawned some unusual new means of doing so.

For example, to reduce their dependence on short-term liabilities, firms have found it necessary to employ such innovative long-term financial instruments as bonds with warrants attached and extendable notes. The bonds with warrants entitle investors to buy more bonds at a fixed coupon rate within a stated number of years. Several of these issues were floated earlier this month, indicating that issuers believe the recent rate decline will be only temporary. But since the warrants are only valuable if interest rates fall, the market's acceptance of these issues at yields lower than those of straight debt issues of comparable maturity reflects investors' sentiments that interest rates may fall still further. With the extendable notes, corporate issuers are able to satisfy investor demands for short-term instruments, while retaining the option to lengthen the maturity of the debt at a pre-designated point in time. There has been a rash of these issues over the past month—also with yields below comparable straight debt.

As a means of lowering firms' overall debt ratios, debt repurchases have gained in popularity since 1979—primarily because the general rise in interest rates has enabled firms to buy back outstanding issues at a profit. More and more, however, this practice has been limited by the lack of a viable source of funds: Additional debt raises financing costs with no improvement in leverage, while new equity dilutes current stockholders' positions, and retained earnings lower liquidity and force the gain to be taxed as ordinary income.

As an alternative to debt repurchases, over the past few months firms have increasingly relied on "defeasance" to reduce their overall debt ratios. Through this practice, a company assigns its debt obligations and a sufficient quantity of government securities to a trustee, who then uses the revenue from the securities to pay the principal and interest on the debt as they come due. The result is that the firm reduces its leverage, saves interest expense, and records a capital gain on the debt, which is taxed at a lower rate than ordinary income.

It is still too early to conclude whether these developments will continue—bringing significant improvements in corporate financial structures—or whether the current "window" in the bond market will be closed by an excess supply of new issues. If the latter proves to be the case, some of the recent financial innovations may become permanent fixtures in corporate financial strategies.

Carl Alan Batlin

OF PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				August 11, 1982			
se of IMF redit, mil- s of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars	change from year earlier	current monetary conditions	
362	IMF Extended Fund Facility arrangement formally cancelled.	April	+13%	March	+7%	.0625	−1%	No 1982-83 bank borrowing for deficit financing planned.	**Bangladesh**
50	Aid donors' recent pledges of assistance near last year's level.	Jan.	+2%	Apr.'81	+13%	.1320	−2%	Inflation remains low.	**Burma**
492	Jan.-June trade surplus was $2.4 billion; import restrictions continue.	Dec.	+3%	March	+16%	.5192	−9%	Increased personal saving boosts housing construction.	**China, People's Republic**
—	Trade deficit appears to be improving compared with 1981.	Nov.	+17%	Nov.	−1%	.1637	−6%	Credit demand soft; rates may fall modestly.	**Hong Kong**
274	Refunds of excise and customs duties on exports expanded.	April	+8%	Jan.	+11%	.1035	−8%	Credit restraint eased slightly.	**India**
0	Trade account depends on oil prices and OPEC quota.	April	+9%	March	+29%	.0015	−6%	Money is tight and interest rates high.	**Indonesia**
0	No clear signs of export pick-up but imports remain sluggish.	June	+2%	May	+2%	.003799	−10%	Long-term prime, bank debenture rates may be raised.	**Japan**
264	Foreign demand depressed; improved trade gap depends on curbing imports.	June	+5%	March	+3%	.00145	−3%	Financial reforms may make credit tight for some.	**Korea**
271	Tin producers' association formed with Indonesia and Thailand.	May	+6%	April	+8%	.4231	0	Mammoth $1 billion commercial bank loan undertaken.	**Malaysia**
993	New import liberalization steps include removal of protection for yarn industry.	April	+10%	April	+8%	.0920	−10%	Reserve outflow held FY 1981-82 M2 growth to 12%-13%.	**Pakistan**
868	Aid group pledges $1.2 billion in development assistance for 1983.	Jan.	+18%	April	+4%	.1120	−14%	New deposit rule creates captive market for securities.	**Philippines**
0	Trade deficit will probably widen.	April	+5%	March	+14%	.4605	−1%	Government may move to slow entry of new banks.	**Singapore**
359	Aid consortium pledges $668 million in assistance this year.	April	+13%	March	+15%	.0495	−15%	Money growth, inflation likely to reaccelerate this year.	**Sri Lanka**
0	Trade surplus probable in 1982 as imports fall.	Jan.	+9%	Jan.	+11%	.0280	−3%	Credit conditions improving; rates may decline.	**Taiwan**
653	Jan.-June trade deficit narrowed sharply with drop in imports.	May	+5%	Dec.	+2%	.0450	−5%	Consumer-price inflation of 7% expected in 1982.	**Thailand**
0	Capital inflows continue, offsetting current-account deficits.	March	+11%	April	+2%	.9795	−14%	Money growth above target for fourth year in row.	**Australia**
17	Current-account deficit widens.	March	+16%	Feb.	+7%	.7285	−12%	Interest rates frozen, credit will be tight.	**New Zealand**
49	Trade balance deteriorates owing to low world commodity prices.	Dec.	+6%	April	−9%	1.3500	n. a.	Government raises commercial bank lending target by 11%.	**Papua New Guinea**

World Interest Rates

market rates as of Aug. 11, 1982; bond yields as of Aug. 6, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	11.00	15.20	11.50 intervention rate	13.50	9.50	7.50	19.00 penalty rate 22.00	8.00	5.50	5.50
Day-to-Day Money	10.875 August 12	18.50	11.875	9.00	14.50	9.00	19.75	9.50	2.00 1-month Euro-Swiss fr. rate	7.4375
Treasury Bills 91-day, Middle Rates	9.92	14.95	11.00	14.25	15.63 1 year	n. a.	17.40 7° days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	11.50 finance paper discount basis	15.40 finance paper 15% tax w/h	10.515	13.40 Certified	14.50 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	11.35	15.30 15% tax w/h	11.00	13.40 Certified	not traded	9.40	21.10	no market	4.625	no market
Government Bonds Long-term, new and old issues, average yield	13.46	15.68	12.58	10.384 20% tax w/h	15.31	9.15	20.48	10.30	4.85	8.102
Industrial Bonds prime, long-term, new and old issues, average yield	15.30 Aa industrials	16.17	13.86	14.013	16.45	9.26	20.25	11.35	5.90	6.50
Bank Short-Term Rate to Best Borrowers (prime rate)	15.00	17.00	12.50	17.25	16.60	12.00	21.75 ⅛ qtrly fee on outstdng.	10.50	9.00	6.00
Bank Time Deposits 3-month	11.375 Cert. of Dep.	15.40	11.375	14.15	14.50	9.10	11.50	9.375 large deposits	3.50 residents only	3.75
Eurocurrencies 3-month, asked	12.875	16.00	11.50	no market	17.00	9.125	no market	9.375	4.375	7.5625
Exchange Rates—in U.S.$ rates floating against the $	—	.7983	1.6965	.02075	.1425	.3964	.000711	.3600	.4642	.003796
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	3.157 *D*	1.415 *P*	1.234 *D*	4.211 *D*	3.834 *P*	7.314 *D*	3.556 *P*	8.789 *P*	5.585 *P*

Eurodollar Deposits
(London, interbank, bid)
August 12

7-day	11.1875
1-month	11.5625
3-month	12.5625
6-month	13.50

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.344
U.S.-Canada Treasury Bills	−1.138
U.S.-Canada Finance Co. Paper	−0.532
Eurodollars-U.K. Local Auth. Deposits	+0.148

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	14.00
Over 7 yrs.	14.75
DM Bonds	
7 yrs. and under	9.125
Over 7 yrs.	9.25

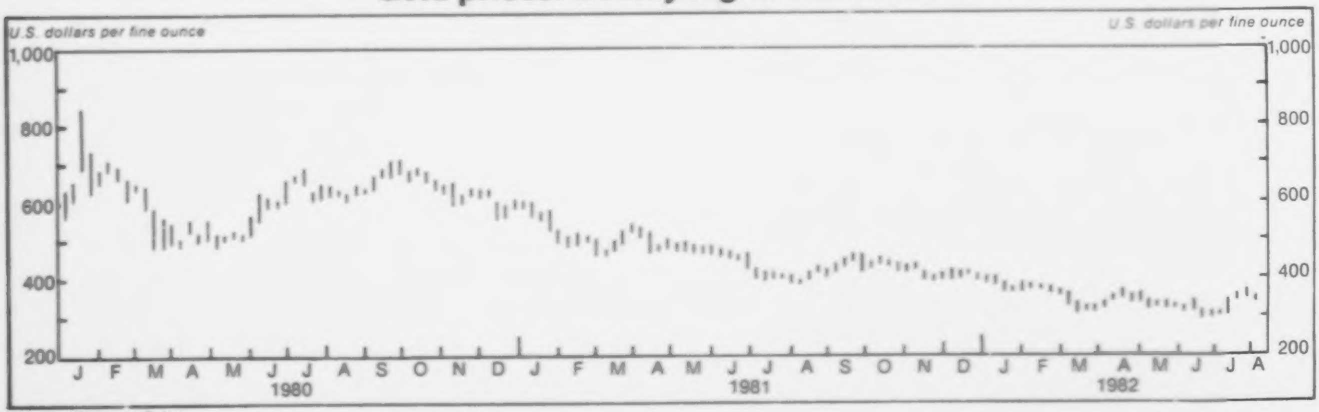
Gold Price

London
afternoon fixing

333.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Gold prices: weekly highs and lows*



* London afternoon fixing

What Drives the Golden Chariot

The price of gold has fallen back somewhat in the past two weeks, after a month-long rally that took it from just under $300 per ounce in late June to well over $360 toward the end of July (see chart, page 6). Although analysts seem to agree that the latest price gyrations can be attributed largely to movements of U.S. interest rates, they disagree sharply over such fundamental questions as what forces move gold prices over the longer term, whether the recent retreat will continue, and how far it will go. To a large extent, these disputes reflect a conflict over the proper approach to forecasting gold-price swings.

One prevalent method is to analyze flows of new supply and demand to the market (see table below). For example, Western production figures receive considerable attention. And some observers point to Soviet gold sales and to official purchases and sales of gold as prime movers of gold prices. There is little evidence, however, that these flows have had any discernible effects on gold prices over the long run. To the contrary, non-Communist mine output has remained remarkably stable over the years, even as the gold price has fluctuated dramatically. And Communist-bloc sales to the West during 1980 and 1981—years that witnessed a sharply *falling* trend in gold prices—averaged well below the levels of such sales during the late 1970s, when the price of gold trended sharply upward. As for "official" institutions, governments and central banks were large net *buyers* of gold during the price slump of 1980-81, after several years as net sellers while gold prices were rising.

In fact, the analysis of supply and demand flows offers little help in the case of a highly durable commodity such as gold. These flows are overwhelmed by even small adjustments in the "stock" demand for *holding* gold relative to the *existing* supply of aboveground gold. Investors will be just willing to hold the entire stock only at a price that balances it with the stock demand, which reflects the relative attractiveness of gold as an asset in the portfolios of central banks, private institutions, and individuals. Gold flows can be considered an equilibrating mechanism; purchases and sales reflect differences of opinion among market participants over the determinants of—and the price that will balance—stock demand and supply.

This has led some analysts to the view that gold-price movements result primarily from such influences as interest rates and political tensions—which affect the desirability of holding gold and thus can lead to portfolio adjustments by asset holders. To be sure, these forces have often caused temporary shifts in stock demand; but they do not appear to have had a lasting effect. For example, recent political tensions have elicited a much milder—and briefer—reaction than those of a few years ago, as investors have gained experience. And while falling short-term U.S. interest rates undoubtedly influenced the July gold rally, the effect appears to have been transitory; the gold price is now well below its level at the end of 1981, even though short-term rates have fallen about three percentage points from their year-end levels.

A more reliable influence on the stock demand for gold—and thus a promising key to future gold-price movements—is the state of general inflation expectations. There is good reason to believe that anticipations of future U.S. inflation, on average, are now well above the current rate of inflation. This suggests that if the markets ever decide that low inflation is here to stay, expectations will converge toward the current moderate rate of increase of the overall U.S. price level, leading to a further sharp reduction in the price of gold. On the other hand, signs of a more accommodative monetary policy could confirm the markets' worse fears of reaccelerating inflation and send the gold price soaring once again.

Ronald A. Krieger

GOLD FLOWS

Components of Supply (metric tons)

	Non-Communist mine output	Net trade with Communist bloc	Net official sales (purchases)	Total
1972	1,182	213	(151)	**1,244**
1973	1,116	275	6	**1,397**
1974	1,005	220	20	**1,245**
1975	953	149	9	**1,111**
1976	969	412	58	**1,439**
1977	970	401	269	**1,640**
1978	975	410	362	**1,747**
1979	960	199	544	**1,703**
1980	946	90	(230)	**806**
1981	962	283	(260)	**985**

Components of Demand (metric tons)

	Total fabrication			Net private bullion purchases (sales)	Total
	Carat jewelry	Official coins	Other		
1972	999	63	283	(101)	**1,244**
1973	518	54	288	537	**1,397**
1974	224	287	224	510	**1,245**
1975	523	251	209	128	**1,111**
1976	935	182	267	55	**1,439**
1977	1,003	142	275	220	**1,640**
1978	1,008	287	308	144	**1,747**
1979	738	290	296	379	**1,703**
1980	123	185	234	264	**806**
1981	594	201	241	(51)	**985**

Data: Consolidated Gold Fields Ltd.

Gold Standard or 'Real Standard'?

The failure of long-term U.S. interest rates to decline in the face of substantial improvement in U.S. inflation suggests that market participants are extremely uncertain regarding the longer-run outlook for inflation. Indeed, the debt market's continued skepticism regarding Federal Reserve policy is in substantial risk of thwarting a U.S. recovery and prolonging the worldwide downturn in real economic activity.

The Fed is faced with an apparent dilemma: It is "damned if it does" loosen up (long-term interest rates may increase for fears of renewed inflation) and "damned if it doesn't" (long-term rates may remain inordinately high). However, this dilemma is probably the result of considering too restrictive a set of policy options. An alternative proposal—which departs from the usual menu of monetary policy choices—is the "real standard" of monetary control: central bank convertibility into fully indexed government debt.

The real standard is motivated by the serious concerns of current advocates of the gold standard—to provide a rule to eliminate both inflation and the volatility in world financial markets. However, while the gold standard is an antiquated option, not suited for today's sophisticated financial environment, the real standard *depends* on the sophistication of today's markets. It consists of two parts: The first is full indexation, requiring that both interest payments and principal of government debt grow according to the rate of inflation. The second consists of a monetary rule requiring the central bank to maintain convertibility of its liabilities (paper money and commercial bank reserves) into the indexed debt—that is, a requirement that the central bank "peg" the market price of the indexed debt.

Debt indexation is not a novel idea, nor is central-bank market intervention in debt markets to fix the market price of *non*-indexed debt. However, intervention to fix the market price of fully indexed debt not only is novel but also has far-reaching implications.

First, by full indexation of government debt, bondholders would be guaranteed that the interest payments and principal would not be eroded by inflation—thereby eliminating inflation uncertainty in the government securities markets. To the extent that long-term interest rates now reflect this uncertainty, these rates would decline, perhaps substantially.

Second, by requiring the central bank to maintain convertibility into indexed debt, the monetary authorities would be prevented from running monetary policy at their own discretion. Therefore, monetary policy uncertainty would be eliminated, sharply reducing financial and foreign exchange market volatility.

Third, convertibility into indexed debt links the market interest rate on that debt directly with the price level. As a result, the central bank would be unable to follow an inflationary policy. For example, if the monetary authorities attempted to pursue expansionary measures, thereby putting upward pressure on prices, the market would respond by raising the interest rate on indexed debt. As a consequence of the rise in the interest rate on the debt, bondholders would increase their demand for the indexed debt, and, because of the convertibility arrangement, the central bank would be forced to sell them the bonds they desired. However, the sale of the indexed debt would retire money, thus putting *downward* pressure on prices. This adjustment would proceed until *all* of the excess money originally issued had been retired—that is, until the initial inflationary policy was thwarted.

Government officials are currently studying fundamental changes in the institutional environment of fiscal policy, including such devices as the proposed Balanced Budget Amendment and the uniform income tax rate. Perhaps the range of alternatives available for the conduct of monetary policy should also be extended to include serious consideration of monetary discipline through the real standard. *W. Dayle Nattress*

Quarterly Euromarket Report

($ billion, end of period)

Total Market Size	IIQ/81	IIIQ/81	IVQ/81	IQ/82	1979	1980	1981
Gross Size (Claims)	1,347.0	1,423.6	1,542.4	1,556.3	1,111.0	1,321.9	1,542.4
Net Size (Claims)	825.0	875.0	940.0	945.0	665.0	810.0	940.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	286.0	292.8	303.7	303.7	269.7	287.5	303.7
Liabilities to Private Nonbank Foreigners	83.6	90.6	94.3	96.9	65.9	75.0	94.3
Total Claims on Foreigners	405.9	421.7	444.9	456.4	324.2	385.4	444.9
Claims on Foreign Public Borrowers	50.7	54.9	59.1	59.8	42.0	48.9	59.1
Claims on Foreign Private Nonbank Borrowers	145.3	148.6	161.4	162.6	117.8	139.9	161.4

Note: Gross and net Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.
Source: Chase Manhattan Bank estimates based on BIS and national data sources.

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Whatever Happened To the European Recovery?

Europe's long-awaited economic recovery has been delayed yet again. Originally scheduled to arrive at the start of 1982, the upswing was subsequently rescheduled for mid-year. But by mid-year it became clear that, while inflation was falling, output was flat if not declining, and leading indicators were, at best, lackluster. What went wrong?

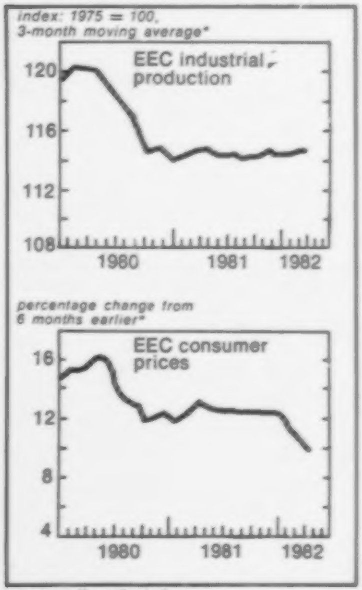
One part of the answer lies beyond Europe's shores. Recessions in the United States and Japan have proved longer and deeper than originally expected. At the same time, OPEC and the non-oil-producing developing countries, faced with falling revenues, have cut back imports.

The other part lies in the interplay of uncertainty, interest rates, and fiscal stance at home. Despite an outward appearance to the contrary, fiscal policy has been tightened in most European countries as governments have countered recession-induced rises in public-sector deficits by tightening spending and raising taxes. The view is that, in the longer run, lower deficits are necessary for a lower and more stable rate of monetary expansion—and lower interest rates. And this, in turn, is a precondition for stable, non-inflationary growth. In the short run, however, real demand was deflated but real interest rates failed to decline—partly because of financial-market doubts about the longevity of fiscal rectitude.

In addition, although Europe's monetary policies were eased somewhat in the first half of 1982, the uncertainty created by the recession and by the post-1979 instability in American interest rates led to an upward shift in the worldwide demand for liquidity, holding interest rates—in relation to inflation rates—well above their historical levels, depressing investment expenditures. That same uncertainty has also raised personal savings rates and therefore depressed consumption expenditures.

In short, policymakers' hopes that a marked fall in inflation rates would be sufficient to stimulate real growth so far have been frustrated. However, not all is bleak. Supply conditions are adjusting for non-inflationary growth: Falling real commodity prices are improving Europe's terms of international trade, inflation expectations are easing, and real wages in most countries are no longer rising faster than productivity. Furthermore, interest rates at last appear to be declining. The dilemma for Europe's policymakers is to judge whether lower inflation alone will be sufficient to raise real demand, or whether a boost to *nominal* demand—effective only if the above supply conditions are sufficiently advanced—will be necessary. The evidence to date suggests that policymakers believe the former, but early 1983 may well bring a change of heart.

European industrial output and inflation



* seasonally adjusted

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Canadian indicators point to GNP decline for 1982.

Soft spots in the Canadian economy are continuing to surface and official economic indicators offer little encouragement for the near-term outlook. Residential construction dropped sharply in the second quarter and business investment in plant and equipment also turned down—both partly the result of high interest rates. The investment decline, however, was also related to a deep erosion of corporate profits that has been evident since mid-1981. In this environment, the unemployment rate has jumped to a record level of 11.8% in July and seasonally-adjusted retail sales fell 4%. The export sector has shown larger surpluses this year but this is due more to declining imports than to export strength. There are expectations that export momentum will pick up toward the end of 1982, but this is contingent on an upturn in the U.S. and other world economies. A recent decline in Canadian interest rates could also provide a boost to investment later this year. The slowdown of economic activity that has already taken place, however, suggests a real GNP decline of about 2.5% for 1982.

French inflation eases—but for how long?

The price-control measures introduced by the French government in June, have produced a reduction in French inflation better than had been expected in official circles. The consumer price index is provisionally estimated to have increased by only 0.3% in July, following a rise of 0.7% in June. The increase in consumer prices over the past twelve months has now slipped to 11.9% and seems likely to fall below 11% by year-end. However, doubts remain as to whether this artificially induced slowdown will prove temporary or permanent. First, the government has yet to secure agreement on a voluntary incomes policy for when the wage-price controls are lifted at the end of October. Second, energy prices, which have been held down recently, are set to rise sharply when the freeze expires. Third, company profit margins have been severely squeezed over the summer months, raising the specter of some catch-up price increases at year-end. All in all, there is some danger that inflation may rebound to 13% next year when, elsewhere, inflation is expected to show a continued marked decline. Moreover, the current stance of French economic policy offers little hope of a significant and lasting reduction in French inflation.

Korea takes first steps toward liberalizing financial system.

The Korean government is following up its earlier economic stimulus program with reforms designed to liberalize the country's financial system. As of August 2, the government now permits individuals—although not corporations—to establish firms to make short-term loans. Previously, such financiers operated without official sanction. In addition, the government has announced the sale on September 9-10 of its controlling interest in two of Korea's banks. This will leave only one large commercial bank with substantial government ownership. In effect, however, the authorities will still retain control of savings and investment through interest-rate ceilings and lending quotas. Any significant opening up of the financial system will require steps toward eliminating these regulations.

Bangladesh adopts program of restraint in view of limits on economic aid.

The government of Bangladesh has announced a number of tough new economic measures in its budget for fiscal 1982-83, which began July 1. To reduce subsidies and increase the profitability of public-sector corporations, the government has instituted price increases amounting to 41% for petroleum products, 40% for electricity, and 14% for chemical fertilizers and has raised the prices for wheat and rice distributed through the ration system. New taxes on luxury goods and farmland will raise 1.3 billion taka, although some other taxes have been reduced or eliminated. In addition to these measures, the government took steps even before the budget was announced to slash development spending to T27 billion—the same level as last year and a figure much more realistic than the T33 billion originally planned, given the amount of aid currently available. For the longer term, prospects for any significant increase in foreign assistance are not at all favorable. Consequently, the government will have to mobilize substantially more resources domestically over the next several years to keep development spending from being severely constrained.

New Italian government raises taxes, cuts spending to trim public deficit.

Italy's two-week-old government crisis now seems set to resolve itself with the formation of a new government, again under Prime Minister Spadolini. This would save—at least for the time being—the austerity package agreed upon by the outgoing cabinet in response to the public sector's rapidly rising borrowing needs. Had policies remained unchanged, the public-sector borrowing requirement (PSBR) looked set to exceed this year's original target of 50 trillion lira by some 15-20 trillion lira and to show another sharp rise in 1983. The new measures include increases in gasoline taxes, higher rates of value-added tax, a 5-percentage-point rise in corporate-income-tax rates, and higher social security contributions by employers. These measures, which go into effect immediately but still require subsequent parliamentary approval, are expected to reduce the 1982 PSBR to 60 trillion lira. Envisaged spending cuts of up to 30 trillion lira and further tax increases would hold the 1983 PSBR to 63 trillion lira. These measures, if implemented, would reduce public sector borrowing from about 14% of GNP this year to about 12% next year.

Turkish trade deficit narrows; but inflation, other problems still confront policymakers.

Turkey's trade balance showed a further improvement in the first half of this year. The trade deficit narrowed to $1.7 billion in the first six months, compared with a gap of $2.3 billion for a comparable period in 1981. Exports rose by some 26% to $2.4 billion. At the same time, imports fell slightly to $4.1 billion, from $4.2 billion last year, mainly as a result of weaker prices for oil and dollar-denominated commodities. While real GDP growth is now expected to exceed 1981's official figure of 4.4%, all is not rosy. Turkey's financial system has recently experienced a series of major bankruptcies. In addition, both wholesale and consumer price inflation have started to rise again, the latter from a rate of just under 30% at the end of last year to some 36% by May. The country's new economic policymakers now face the difficult task of restoring confidence in the financial system while checking the rate of monetary expansion without aborting the recovery in real output.

Growth slowdown, worsening payments imbalance seen for Zimbabwe.

Contrary to expectations, Zimbabwe's real economic growth accelerated in 1981 to a rate of 12.9% from 11.7% in 1980, according to provisional figures. This was accompanied by only a moderate increase in the rate of inflation to 12.3%. Imports rose some 24%, while exports increased only marginally; consequently, the traditionally positive trade balance swung into an estimated $140 million deficit. Sharply higher deficits on investment income and transfer accounts also contributed to the widening of the current-account deficit, which rose to an estimated $175 million, from $290 million in 1980. Estimates place capital inflow—predominantly borrowings—at only $165 million, pointing to an overall payments deficit of $550 million for 1981. For 1982, economic growth is likely to be dampened substantially by drought-reduced maize and cotton crops and weak export demand. In the external sector, the anticipated slower rate of import growth may not fully offset the deteriorating export performance. However, for the overall balance of payments, aid inflows and lower investment income outflow could mitigate some of the effects of a worsened trade account.

Coffee harvest expected to fall sharply in coming year.

Thanks to a record harvest for the crop year just ending, the 1982/83 coffee season will begin in October with an unprecedented level of producer stocks at 44.7 million bags—nearly 50% of current world consumption requirements. With the relative price of coffee moving lower in the near term, consumption is anticipated to increase by 1 million bags to 84 million, despite the recent declining trend in per capita consumption. Output in the coming year, however, is expected to show a sharp turnaround from the past year. Latin American producers have already sustained major losses owing to frost and drought, and current forecasts project production will be down nearly 20% to 81 million bags. Currently, the International Coffee Organization's export quotas are being decreased in order to maintain prices near $1.40/lb.—the upper limit of the group's preferred range—and they are likely to remain high through January.

New Tax Act Reshapes Fiscal Policy

The large tax increase recently enacted in the United States clearly modifies—but does not reverse—previous trends in U.S. fiscal policy. Future federal deficits will be somewhat smaller than they would have been under prior law—and so will the incentives for business investment.

For most American individual and corporate taxpayers, the new law promises relatively minor changes over the next year or so. Receipts will be raised by an estimated $18 billion in fiscal year 1983, which begins this October 1. That represents an increase of only about 3%. The incremental boost to taxes, however, will double in fiscal 1984 and grow significantly in later years. But while this may reduce future deficits, it will not be sufficient to reverse their essentially upward trend.

Previous private estimates of the 1983 deficit had ranged as high as $180 billion, with the expectation that deficits would increase in succeeding years. The new tax law may generate enough revenue to hold those deficits in the neighborhood of $150-160 billion. Official estimates of future deficits are much smaller than this. But they assume faster economic growth than is anticipated by most private analysts and also reductions in spending that have yet to be legislated.

To the extent that huge future federal deficits threatened to keep interest rates high and to generate related difficulties in financing private economic activity, the outlook has been improved somewhat, but the problem has not been solved. Substantial economies will be required on the spending side of the federal budget before these major concerns of the money and capital markets are effectively eliminated.

The new law also significantly alters or offsets some of the provisions of the massive reduction in taxes that was enacted in 1981. The 1981 act had two major objectives: to reduce the overall burden of Federal taxation on the private economy and, in specific ways, to provide greater incentive to private saving and investment. When fully effective in the mid-1980s, the new law will offset about 20% of the reductions provided for in the 1981 act. But the distribution of this offset between individual and business taxpayers—and between the various incentives to saving and investment previously enacted—varies greatly.

As a general proposition, the burden of the new tax provisions falls more heavily on business than it does on individual taxpayers. This is true both in absolute terms and in terms of changes in the tax incentives enacted in 1981. By fiscal 1986, business will be providing well over half the increase in tax revenue provided for in the new act. And the proportion will

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE			
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered
Argentina	New economic program attempts to revive industry through subsidized credit and export stimulus.	March	+ 8%	128.0	$4,547	April	2,806	−46%	3.1
Brazil	Economy at low levels of activity while inflation rate moves upward.	April	−11%	284.8	2,307	June	5,835	+12%	3.2
Chile	Government banks make $225 million available to construction, manufacturing, and agriculture.	June	− 4%	35.3	3,126	June	2,742	−16%	7.9
Colombia	New monetary measures aimed at increasing liquidity and economic output.	April	+12%	37.3	1,399	June	4,301	− 7%	9.9
Dominican Rep.	Tax revenues from exports and imports down sharply, result: large growth in fiscal deficit.	March	−13%	7.3	1,314	June	81	−57%	0.7
Ecuador	New law permits services contracts for oil exploration by international companies.	April	−10%	13.4	1,634	June	571	−23%	3.3
El Salvador	Estimate for 1981-82 coffee output set at 2.38 million bags—11% below previous year.	April	− 4%	3.3	666	June	89	+ 2%	1.2
Guatemala	Tourism earnings for 1982 projected at $61 million—81% below last year.	March	−14%	9.0	1,239	June	142	−48%	1.2
Haiti	IMF approves SDR 34.5 million standby program designed to reactivate economy, reduce fiscal deficit.	Feb.	− 2%	1.7	365	May	8	+11%	0.3
Honduras	Economic activity continues to deteriorate with no improvement in sight for near future.	Nov.	− 2%	2.7	710	April	104	−17%	1.3
Jamaica	Prospects favorable for further reduction in bauxite levy.	April	−28%	3.1	1,410	June	118	+20%	1.0
Mexico	International financial support program being organized for external debt payments.	April	+ 4%	238.7	3,303	May	3,920	+15%	2.5
Panama	International banking activity at high levels, but domestic economic conditions are slow.	March	−34%	3.8	2,027	April	94	− 8%	0.7
Paraguay	Economic activity slowing because of delays in hydroelectric projects.	April	+ 7%	5.4	1,664	June	794	− 1%	13.6
Peru	All government departments required to stick to 3-month cash budgets.	March	−17%	21.0	1,160	Dec.	1,209	−39%	3.7
Puerto Rico	Slight modification in business taxation affecting Puerto Rico included in U.S. tax-increase.	May	−13%	11.[illegible]	3,658	June	10,928*	+ 6%	16.0
Uruguay	Economic recession worsening; new tax and salary measures introduced to limit growing fiscal deficit.	Dec.	− 7%	10.9	3,711	July '81	403	− 5%	3.2
Venezuela	Softer petroleum prices will mean continued economic stagnation.	Feb.	− 9%	69.4	4,454	June	6,528	−27%	6.8

*Commercial Bank Deposits

grow rapidly in later years. Almost all businesses will be affected in some degree, although the burden of the new provisions will fall most heavily on those that make large capital investments.

Many individual taxpayers, by contrast, will feel little or no direct effect from the new law. Most of the increase in personal taxes will be paid by those who previously underpaid their taxes or who have significant amounts of income that will be subject to withholding tax for the first time. The withholding process will be extended to tips received by waiters and waitresses and to recipients of interest and dividend payments. In both cases, however, exemption from this provision will be available for many of those recipients.

The new law varies even more extremely in its treatment of the incentives to savings and investment enacted in 1981. For individuals, these incentives took two important forms. First, the top rate on the individual income tax was reduced to 50% from 70%, and a series of annual reductions in all tax bracket rates was adopted; the series was made perpetual by the adoption of indexing starting in 1985. These reductions are unaffected by the new law. Second, sizable reductions in taxes on earnings from savings and on estates and gifts were scheduled under the 1981 act. These, too, are untouched by the new law.

By contrast, much of the newly-enacted increase in business tax payments will come directly from changes in the investment incentives previously scheduled. This is true in only modest degree for the next two years. During that period, much of the increase in business taxes will come from a variety of changes in accounting rules, a rise in the tax paid to support the unemployment compensation system, and acceleration in corporate income tax payments. Most of the alterations in investment incentives, of which there are several, will individually produce relatively minor amounts of revenue during this period. (This does not mean that their effect on the companies directly involved will be minor. Repeal of "safe harbor" leasing as of 1984 will be extremely important for some.) In the mid-1980s, however, the emphasis of the new tax provisions shifts heavily to reduction of incentives for investment.

By fiscal 1987, the combination of changes in treatment of the Investment Tax Credit, the new rules on tax treatment of leasing, and—most important—repeal of the 1981 provision for accelerating depreciation in 1985 and 1986 will produce additional revenues of an estimated $31 billion. This is almost exactly half of all the additional revenue expected from all provisions of the new tax law in 1987. Repeal of the 1985-86 acceleration in depreciation will, by itself, account for more than half of the change in business tax revenues associated with investment by 1987.

Richard W. Everett

Of PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				exchange rate in U.S. dollars	change from year earlier		
se of IMF edit, mil- s of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	August 25, 1982		current monetary conditions	
0	Multiple exchange system expands to 17 rates.	July	+137%	May	+132%	.000043	−83%	Deposit and loan rates regulated.	**Argentina**
0	Pace of mini-devaluations increasing.	July	+100%	April	+ 74%	.0060	−52%	Domestic interest rates remain at high levels.	**Brazil**
23	Currency currently trading in the vicinity of 55 pesos per dollar.	May	+ 4%	March	− 2%	.0174	−36%	Domestic credit being expanded.	**Chile**
0	Increase in government export credit lines.	June	+ 24%	April	+ 24%	.0160	− 24%	Bank loans show large rise.	**Colombia**
60	Prospects for external accounts bleak in foreseeable future.	Jan.	+ 6%	April	+ 12%	Par	—	Credit to public sector rising.	**Dominican Rep.**
0	Oil export earnings decline because of price softness.	April	+ 12%	Jan.	+ 12%	.0174	−50%	Interest rates rise.	**Ecuador**
41	Parallel foreign exchange market to be established soon to halt black market.	April	+ 11%	April	+ 3%	.4032	0	Liquidity is tight.	**El Salvador**
104	June international reserves totalled $142 million, vs. $273 million year earlier.	April	+ 1%	March	− 1%	Par	—	Net foreign assets falling.	**Guatemala**
34	Government attempting to reduce payments arrears.	Dec.	+ 17%	Feb.	+ 15%	.2050	0	Domestic credit increased slightly.	**Haiti**
61	More stringent import controls and slower GDP growth will lower imports.	April	+ 10%	Feb.	+ 1%	.50018	0	Net foreign assets on the decline.	**Honduras**
492	Tourism improving; first quarter earnings 44% above year-earlier.	April	+ 7%	March	+ 13%	.5700	0	Credit growth contained as part of IMF agreement.	**Jamaica**
0	Three exchange rates set for currency.	May	+ 45%	March	+ 37%	.0095	−77%	Domestic liquidity highly limited.	**Mexico**
86	Re-exports to Latin America decline.	May	+ 4%	Dec.	+ 10%	Par	—	Local time-deposit rates increase.	**Panama**
0	Controls placed on foreign exchange sales.	Feb.	+ 6%	Feb.	− 4%	.0080	0	Monetary policy is restrictive.	**Paraguay**
322	Faster pace of mini-devaluation—about 5%-6% per month—will be maintained.	April	+ 61%	April	+ 46%	.0016	−36%	Credit policy is tight.	**Peru**
—	Imports decline during April-May.	June	+ 4%	June	+ 6%	Par	—	Loan growth slowing.	**Puerto Rico**
0	Reserves continue to fall; possible maxi-devaluation by year-end.	March	+ 22%	Feb.	0	.07781	−14%	Net foreign assets dropping.	**Uruguay**
0	Oil output at 2.1 million bpd—above OPEC ceiling set earlier this year.	May	+ 12%	March	+ 5%	.2300	− 1%	International reserves continue to fall.	**Venezuela**

World Interest Rates

market rates as of Aug. 25, 1982; bond yields as of Aug. 20, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	10.50	14.26	11.25 intervention rate	13.52	9.50	7.50	19.00 penalty rate 20.00	8.00	5.50	5.50
Day-to-Day Money	9.125 August 26	17.00	11.625	12.45	14.50	8.80	18.75	8.50	6.25 1-month Euro-Swiss fr. rate	7.125
Treasury Bills 91-day, Middle Rates	7.55	13.70	10.25	13.75	n. a.	n. a.	17.18 92 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	9.625 finance paper discount basis	14.00 finance paper 15% tax w/h	9.961	13.40 Certified	14.625 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	9.35	13.95 15% tax w/h	10.1875	13.40 Certified	not traded	9.40	21.00	no market	4.4375	no market
Government Bonds Long-term, new and old issues, average yield	12.15	14.50	11.46	10.161 20% tax w/h	15.17	8.98	19.88	10.07	4.75	8.521
Industrial Bonds prime, long-term, new and old issues, average yield	14.00 Aa Industrials	15.50	12.96	14.173	16.46	9.02	20.24	11.23	6.19	6.64
Bank Short-Term Rate to Best Borrowers (prime rate)	13.50	16.00	12.00	16.75	16.60	11.50	21.75 ⅛ qtrly fee on outstdng.	10.50	9.00	6.00
Bank Time Deposits 3-month	9.25 Cert. of Dep.	13.75	10.625	13.65	14.6875	8.45	11.50	8.50 large deposits	3.50 residents only	3.75
Eurocurrencies 3-month, asked	10.6875	14.50	10.8125	no market	22.00	8.1875	no market	8.4375	4.125	7.4375
Exchange Rates—in U.S.$ rates floating against the $	—	.8110	1.7560	.0214	.1460	.4108	.000726	.3745	.4866	.003956
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	3.75 *D*	0.125 *D*	3.00 *D*	13.50 *D*	2.50 *P*	9.75 *D*	2.50 *P*	6.50 *P*	3.125 *P*

Eurodollar Deposits
(London, interbank, bid)
August 26

7-day	9.4375
1-month	9.75
3-month	10.5625
6-month	11.6875

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.434
U.S.-Canada Treasury Bills	−1.766
U.S.-Canada Finance Co. Paper	−0.433
Eurodollars-U.K. Local Auth. Deposits	+0.250

Eurobonds
(average yield on recent straight debt issues)

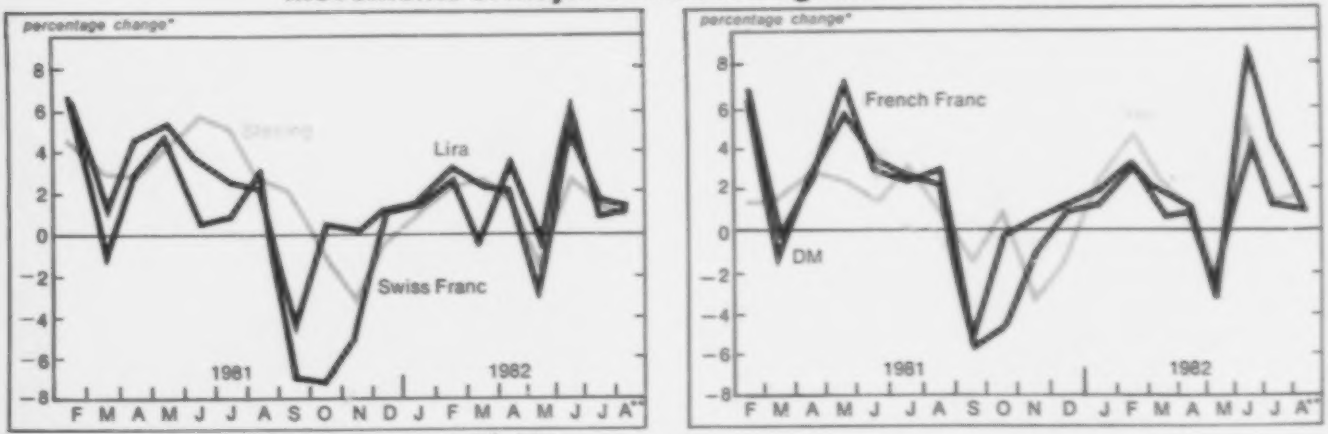
U.S. Dollar Bonds	
7 yrs. and under	13.75
Over 7 yrs.	14.25
DM Bonds	
7 yrs. and under	9.125
Over 7 yrs.	9.125

Gold Price
London
afternoon fixing

401.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Movements of major currencies against the dollar



*monthly average of daily figures, foreign currency units per U.S. dollar
** estimates

Japan's Changing Financial Markets

Editor's Note: The Japanese financial system has undergone rapid structural change since the early 1970s. This is the first in a three-part series examining the evolution of the Japanese financial markets and the implications for monetary control and the behavior of the yen. This article discusses the operation of the postwar financial system through the 1960s—just prior to the period of dramatic change—focusing on how monetary, fiscal, and foreign exchange policies influenced its development. Subsequent articles will review and analyze changes in the system since the early 1970s and consider its probable evolution over the next several years.

The Japanese government has come under increasing pressures in recent months—both from foreign trading partners and from its own financial institutions—to accelerate the liberalization of the Japanese financial markets. Without letting up on demands that Japan restrain its exports and open its domestic markets to foreign products, the United States and Europe have stepped up their criticism of the supposedly closed nature of the Japanese financial markets. In addition, as Japanese budget deficits and the level of outstanding government debt have soared, Japan's financial institutions—the principal holders of government bonds in Japan—have become increasingly unwilling to buy new bonds at below-market rates.

These external and internal forces are compelling wide-ranging reforms of a system that has already undergone radical changes. Until relatively recently, perhaps as little as a decade ago, neither international pressures nor government deficits played a significant role in Japanese policy decisions. Japan was, in effect, a closed economy with a government that, for the most part, maintained a balanced budget. Thus, Japanese monetary policy was insulated from many of the forces that today weigh heaviest on critical decisions. A better understanding of how this environment influenced the development of the financial system will help to shed some light on upcoming changes.

Following the war, when the country was undergoing extraordinarily fast growth, Japanese businesses were unable to generate internally the funds necessary to finance such rapid expansion. In addition, the markets for direct business financing developed only slowly, for a number of reasons. The bond market was initially depressed by high postwar inflation. In subsequent years, however, it failed to mature primarily because of the government's practice of setting the yields for new issues of public and industrial bonds below market-clearing levels. At the outset, this low-interest-rate policy was adopted to promote capital investment, exports, and economic growth in general. It has been perpetuated, however, primarily to limit the cost of government debt financing. The reason why the stock market did not emerge as a major vehicle for business financing is less apparent. One possible explanation may be that the banks—acting as financial intermediaries—were simply more efficient in diversifying risk and in reducing transactions, information, and monitoring costs.

In any event, Japanese firms as a result relied heavily on the banks—that is, on indirect financing—for funds. Moreover, because of the underdevelopment of the bond and stock markets, most of Japan's high level of household savings was channeled into the banking system. Thus, until the mid 1970s, the banks' main function was to funnel the excess of savings in the personal sector to the corporate sector.

During this period, the Japanese banks were strongly dependent on the central bank, the Bank of Japan (BOJ), for funds to support the fantastic increase in credit called for by the postwar expansion. The city banks—those banks headquartered in the major metropolitan areas—provided the bulk of the financing for the country's major firms. These banks were particularly dependent on borrowings from the BOJ, because the demand for loans quickly outstripped the growth in their deposit base, and because of the way in which the BOJ conducted monetary policy in order to supply high-powered money to the banking system.

Conduct of monetary policy

For much of the period, the BOJ focused on the volume of city bank lending and the "call money" rate as its operating targets. (The call money market in Japan is similar to the federal funds market in the United States in which banks make short-term, often overnight, loans to one another. Through the call money rate, the BOJ can affect the volume of non-city-bank lending.) Although technically the operating tools of the central bank included changes in reserve requirements and open market operations, the primary tools used by the BOJ until the early 1970s involved changes in the conditions under which it would lend to the banks and direct controls over bank lending to firms.

Central bank discounts and loans were the main avenue through which the BOJ channeled high-powered money to the banking system. Generally, the monetary authorities set the discount rate below market-clearing levels. This created an excess demand for BOJ money and compelled the central bank to ration credit. The rationing system was formalized in November 1962, when individual loan ceilings were imposed on the ten city banks whose dependence on BOJ borrowings was especially high. The central bank set a penalty rate on borrowings in excess of the ceilings, but excessive borrowing was viewed as being out

Japan's Changing Financial Markets

(continued from page 7)

of the question and never occurred. Even within the ceilings, borrowing from the BOJ was considered very much a privilege, not a right. Since the discount rate was below market-clearing levels, changes in the rate mainly operated through an "announcement effect," foreshadowing a change in the central bank's lending policy. Changes in the BOJ's lending ceilings affected the profit-maximizing level of bank loans both through a direct effect on bank liquidity and through an indirect cost effect, as city banks' borrowing in the higher-cost call-money market was affected.

In order to insure that the burden of adjustment to any tightening of monetary policy fell promptly and precisely on the volume of bank loans, the BOJ supplemented its lending policy with direct quantitative limits on banks' lending termed "window guidance." Window guidance was used only during periods of tight money, and at other times remained essentially in abeyance. Compliance with the window guidance ceilings generally was satisfactory, as the major banks relied heavily on cheap BOJ credit and feared that any violation would result in reduced access to it.

The central bank used changes in reserve requirements only infrequently in the early postwar period. The authorities sometimes raised the requirements, but did so primarily to increase the banks' dependence on the BOJ and enhance lending policy effectiveness.

For much of the period, open-market operations as they are conducted today in the United States were also not an important tool of monetary policy—principally because of the absence of a well-developed securities market, particularly for government securities. The government issued short-term bills to take care of seasonal deficits. However, since rates on the bills were fixed at relatively low levels, private holdings were negligible and they generally were purchased by the BOJ. Moreover, for a time long-term government bonds were not available for these operations, since the government pursued a balanced-budget policy through fiscal 1964. Even when the government began to issue long-term bonds to finance its deficits in fiscal 1965, the open market operations had some unique features.

As mentioned earlier, because of the BOJ's low-interest-rate policy, government bonds were issued at below-market yields and the government's Trust Fund Bureau and syndicates of financial institutions were compelled to underwrite them. Reluctantly, banks were willing to do so only because of their indebtedness to the BOJ and because government bonds could be used as collateral for BOJ loans. Open-market purchases by the BOJ were then allocated among specified banks in specified amounts. Thus, the operations, were, in effect, compulsory changes in the reserves of certain banks, with purchases just another form of central bank lending.

Because of the government's low interest-rate policy, interest rates, in general, were not allowed to perform fully their function of equating the quantity of funds demanded and supplied. Instead, the monetary authorities relied on credit rationing devices at various points in the system: indirect limits on corporate bond issuance (since terms for new issues were set below market-clearing levels), quotas for the conduct of open market operations, ceilings on each bank's discounts from the central bank, and direct limits on the quantity of each city bank's loans. The extent to which market forces were still at work has been widely debated. Nevertheless, the government's low interest-rate policy was, in fact, a major determinant of the structure of the postwar financial system.

Monetary policy effectiveness

Until the mid 1970s, the Japanese government relied on monetary policy as its primary policy tool. The effectiveness of changes in monetary policy was heightened by the heavy dependence of the banks—particularly the city banks—on the BOJ for loans and by the heavy dependence of firms on the banks for financing.

Perhaps equally important to the effectiveness of Japanese monetary policy, however, was the isolation of the economy from the rest of the world through strict foreign exchange (trade and capital) controls. Virtually all capital transactions were subject to government approval, including foreigners' acquisition of stocks, foreign borrowing by nonbank residents, and the transfer of capital and investment abroad. The authorities then eased or tightened restrictions as necessary to prevent undesired capital and reserve flows. These capital controls were particularly crucial in light of the government's desire to keep Japanese interest rates at low levels and in order to prevent Japanese companies from circumventing credit restraint by borrowing abroad.

If the domestic money supply is viewed as varying with changes in the banking system's holdings of net foreign assets and changes in credit to the private sector or to the government, then these exchange controls kept changes in the banking system's net foreign assets a relatively minor influence on changes in the domestic money supply at least until the late 1960s. Changes in net credit to the government were also insignificant, since budget deficits were either nonexistent or relatively minor during this period. Thus, even though the yen was held fixed against the dollar during the early postwar period, the BOJ was able to control the domestic money supply by directly regulating credit to the private sector through its monetary policy instruments.

Melanie L. Lau

CHASE

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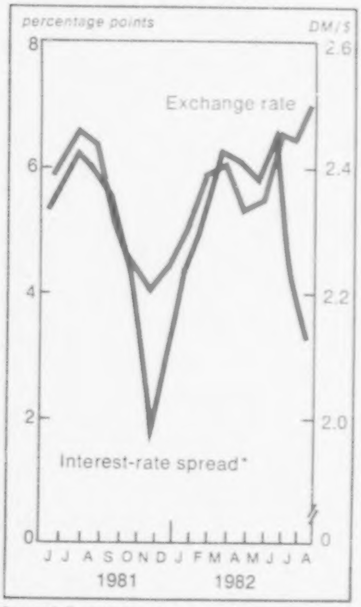
The Dollar's Surprising Strength

The dollar has remained surprisingly strong over the past two months in spite of the rapid narrowing of the spread between short-term interest rates on dollar-denominated assets and assets denominated in other currencies. Since the end of June, three-month Eurodollar rates have fallen roughly 400 basis points. Three-month EuroDM rates have fallen much less over that period—slightly more than 100 basis points—while Euroyen rates have actually risen. Even so, the dollar is now trading at about the same level against the mark and yen as it was two months ago. For the first time in 18 months a significant movement in interest rate differentials has not signalled a sharp movement in the trading range for the dollar.

There is no fully satisfactory explanation for this development. Part of the answer appears to lie in the increased level of uncertainty in financial markets around the world. This summer has witnessed a steady progression of unsettling events. And the result has been something of a flight to assets considered relatively secure—U.S. government debt, gold, and the dollar. It is a measure of the market's confidence in the Federal Reserve's post-1979 commitment to controlling inflation that the dollar should once again have become a "haven currency." In the great bear market for the dollar in 1978-79, unexpected events tended to result in a dollar selloff.

Another reason for the continued dollar support is the perception that this marked narrowing of interest-rate spreads is likely to prove temporary. Foreign monetary authorities appear to be eager to adopt less restrictive policies, and many in the market believe that accelerated money growth—in large part the result of the recent decline in interest rates—will lead to a significant back up in U.S. rates this fall. Indeed, the desire to avoid a repetition of the events of last December, when an abrupt turnaround in U.S. money markets caught foreign policymakers by surprise and the dollar sharply appreciated, would appear to be a major force behind the cautious response of the Bundesbank to the recent fall in U.S. interest rates. The behavior of the exchange markets over the past two weeks suggests that this concern is not misplaced. Since the resolution of the short-term liquidity problems of many developing countries is likely to be some time away, firmed expectations of higher U.S. interest rates could easily lead to another episode of dollar strength.

U.S.-German interest-rate differentials and the DM price of the dollar



*3-month Eurodollar rate minus 3-month EuroDM rate, end of month

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A French budget that should help calm foreign exchange market fears.

The French government's budget proposals for 1983 provide the first evidence to date of a shift in economic policy. The deficit is to be held, as promised, to no more than 3% of GDP or FF 118 billion—a level similar to this year's budget gap. Government plans to keep spending in check by allowing only a 12% increase in nominal terms over levels planned in 1982 proposals. The overall tax burden is not to increase, but it will weigh somewhat heavier on the higher paid taxpayers. The budget's underlying economic assumptions appear a little optimistic compared with private forecasts: real GDP growth of 1.7% this year followed by 2% in 1983, and a sharp drop in inflation from an average 12.3% this year to 8.3% next year. But even if the economy does not respond as well as is hoped, the government apparently plans to stick to a tight policy when the wage-price freeze expires in October, as evidenced, in part, by an official forecast that real personal disposable incomes will rise by only 0.9% in 1983. The foreign exchange market will still wish to see what results from the current wrangling over the wage guidelines that will go into effect after October 31. Nevertheless, the budget proposals should help to assuage fears of an imminent devaluation of the franc.

Finnish government resists pressures for reflationary budget.

The coalition government of Finland is now in the process of putting together its budget for 1983. The budget has not been easy to formulate because Finland's economic growth rate has been steadily falling for some time; 1982 will see virtual stagnation. However, the slowdown represents a normal business cycle brought on both by OECD sluggishness and by a leveling off in export demand from the Soviet Union. With this in mind, the government has resisted calls for widespread reflation and is putting together a budget designed to reduce inflation and to maintain international competitiveness. Inflation will probably average some 9.5% this year but is expected to fall further in 1983. The current account of the balance of payments showed a 482-million-markka surplus in the first half of this year while the year as a whole should see a surplus close to 1 billion markkaa. If exports pick up a little next year as is hoped, the balance of payments should improve further, and GDP should also show more buoyancy.

Knotty economic problems in store for winner of upcoming Swedish elections.

Sweden is now in the midst of campaigning for what is likely to be a close-run general election, scheduled for September 19. Sweden's economy has improved over the last year or so, and 1982's GDP will be about 1% up on 1981's recession level, while inflation will average 8.6% after 12.1% in 1981. The balance of trade will also improve considerably over last year's performance, although increased interest payments on the country's debt will prevent this improvement from being reflected in the current-account balance. However, whoever is elected to form the government will nevertheless face serious economic problems: Manufacturing output is still lower than it was in 1973, the export industries' share of foreign trade has been declining steadily, unemployment is rising, and total public expenditure accounts for almost two-thirds of GDP. As a result, reasonably tough policies can be expected over the next few years—regardless of the outcome of the upcoming election.

Panamanian public spending slows—and so does the economy.

Panama's economic momentum is slowing this year as a result of public-sector spending restraints and a decline in exports to other Latin American countries. Construction and agriculture have also been sluggish, while international banking and related services activities have held up well. Nevertheless, the recessive forces are likely to overpower the buoyancy of Panama's international financial sector enough to push real GDP growth down to 1.5%-2% this year, below the 3.6% of 1981. A more positive development—partly owing to the slowdown, but also the result of declining import prices—has been a drop in inflation to a low 4% annual rate in May. The Panamanian government's restrictive fiscal position is expected to continue in accordance with an IMF standby program which includes ceilings on public-sector deficits and national bank credit to non-financial governmental agencies. One key government goal is to limit the increase of external debt this year within the IMF targets.

Mexico enacts bank nationalization and exchange controls.

The nationalization of private bank deposits and the imposition of exchange controls are the latest actions taken by the Mexican government in a long series of events since a debt refinancing was announced on August 20. These measures represent efforts to halt capital outflow and help the country service its external debt. In addition, the government has requested a 90-day deferral of all public-sector principal payments, and a massive international support program has been launched. About $9.4 billion of actual or proposed credits are included in the Mexican assistance program from a group comprising the U.S. government, central banks of industrial countries, the IMF, and foreign commercial banks. The steps toward economic adjustment that will have to be undertaken to support the IMF and commercial bank credits are likely to mean further fiscal constraints and slower growth for the Mexican economy. Moreover, inflation pressures are also bound to intensify. A resolution of Mexico's external debt situation is going to take time, and it will require the steady adherence to stabilization measures on the part of the Mexican authorities.

India acts to boost exports.

Faced with a sizable current-account deficit, the Indian government has taken a number of steps in recent months to spur exports. The government has granted tax relief to companies that increase their export sales by more than 10% from the previous year. In addition, the authorities have expanded and simplified India's duty drawback scheme, under which excise and customs duties paid on inputs used in export production are refunded. To stimulate production in general and exports in particular, the government has liberalized its restrictions on industrial investment, allowing licensed firms to expand their authorized capacity by one-third above their highest production level in any of the previous five years. The government has also significantly eased import controls, particularly for industrial inputs, and exempted 100% export-oriented units totally from import licensing formalities. Despite these actions, exports this year still may fail to show much improvement because of the continued weakness of the world economy. However, over a longer period, these measures should have a significant impact on India's export capability and on its balance-of-payments performance.

Singapore slowdown reflects depressed world markets.

Singapore has at last begun to feel the effects of the world recession. The country's exports grew at a rate of only 6.6% in the second quarter of this year compared with an average of 25% per year between 1977 and 1980. The government has revised its estimate of 1982 real GDP growth downward by three percentage points, to between 5% and 7%, with the warning that even 5% may be unachievable if there is no economic recovery in the United States. This would represent a substantial slowdown from 9.9% real growth in 1981. Singapore officials have responded to these problems with a new program that includes the creation of a Trade Development Board to promote external trade. The private sector has advocated the establishment of such an organization for years, but the government has resisted. The reversal of policy reflects concerns that the current slump could last another 18 to 24 months.

Qatar's current-account surplus expected to decline.

The persistence of soft world demand for OPEC petroleum will shrink the current-account surplus of Qatar this year. In 1981, the surplus widened to $3 billion —despite a dip in gross oil revenues to $5.5 billion—as a 17% increase in Qatar's average oil price to $37 per barrel was slightly offset by a 14% drop in average oil output to 405,000 b/d. Still, the surplus grew, primarily because of a jump in non-oil income to $1.6 billion (mainly from foreign investments), but also because of a modest 4.5% expansion in imports and transfer payments to $3.9 billion. This year, however, Qatar's oil prices—assuming they hold steady through December—will average $34.60, down 6.5% from last year. Oil output is also down noticeably and could average around 350,000 b/d. If so, oil revenue would shrink by 20% to $4.25 billion and total exports to about $6.2 billion. Accordingly, even if payments for imports and transfers rise by a moderate 4.5% to $4.1 billion, Qatar would register a current-account surplus of no more than $2.1 billion.

Interest Rates and Economic Recovery

The unusually dramatic rally in the credit markets in the last two weeks of August capped a six-week slide in interest rates far sharper than had been generally forecast. The decline touched off a steep rise in the prices of gold and other commodities and one of the strongest stock market advances on record. Sustained strength in these markets would require a smart turnaround in the economy. However, such improvement may not be forthcoming soon.

In general, business plant and equipment spending, the desired level of inventories, and the pace of residential construction are directly affected by drastic changes in interest rates. If the recent drop in rates had occurred in a different economic environment, businesses could now be expected to be a bit more liberal in their capital spending and inventory decisions, and more households would be willing and able to buy new homes.

Given current conditions, however, the economy does not appear to be set for takeoff. Industrial production continued to decline during July—and probably August, as well—keeping capacity utilization below 70%. And end-of-summer retail sales have been relatively weak, considering the boost to personal disposable income from the July income-tax cut and increase in Social Security checks—perhaps in part because unemployment has continued to climb. In addition, mortgage rates are still high enough to restrain real estate activity. Consequently, despite the lower interest rates, neither businesses nor consumers have incentives to spend more freely at present.

Furthermore, expectations about future business conditions remain extremely uncertain, putting an added damper on economic activity, chiefly because of mixed signals on government policy. On the fiscal side, the recently enacted tax increase was passed with the intent of holding the fiscal 1983 deficit below $150 billion. But as the new fiscal year unfolds, it will become clear that the deficit will be considerably larger, embroiling Congress in more debates over further tax increases and spending cuts. With respect to monetary policy, the rapid decline in interest rates and somewhat faster growth in nominal demand have raised concerns about an acceleration in money growth and the probability of interest-rate increases in the fall.

Because of the prospects of a further back up in rates, the economy will be better off in the long run if businesses remain cautious a little longer. To become overly optimistic now and aggressively expand production to build up inventories to take advantage of the currently lower rates could backfire if the remaining uncertainties result in a spending shortfall. Excess inventories could lead to a new round of production cutbacks starting as early as this winter.

Douglas L. Bendt

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF				
			6 months ending	change from year earlier	in billions of dollars	$ per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of I credit, m lions of do
Africa	**Algeria**	Sharp increase in government outlays for housing projects planned.	May	−32%	36.0*	1,935	July	2,666	−20%	3.5	0
	Egypt	Government's development outlays holding steady.	Feb.	22%	22.7*	535	April	705	−20%	0.8	76
	Ivory Coast	Oil exploration activity slows in anticipation of revenues from Espoir field beginning in 1983.	Nov.	−28%	9.8	1,190	May	5	−61%	0.0	433
	Kenya	World Bank approves $136.9 million for continued structural adjustment and agricultural assistance.	March	−5%	6.6	383	July	202	−32%	1.2	350
	Malawi	Fiscal program for 1982/83 aims to increase private sector credit resources.	Feb.	−28%	1.5*	250	July	30	−68%	1.1	70
	Mauritius	Austerity budget for fiscal 1982/83 provides for sales tax and restructured customs duties.	Dec.	−17%	6.5*	675	July	23	+61%	0.5	148
	Morocco	Japan to lend 31 billion yen ($120 million) toward a sulphuric acid plant at Jorf Lasfar.	March	+3%	18.1*	896	June	313	+154%	1.1	724
	Nigeria	Government borrows heavily for its development program.	May	−32%	86.8	1,125	June	1,321	−85%	1.4	0
	Senegal	Recovery of agricultural production expected to return economy to positive growth rate this year.	n. a.	n. a.	2.5*	437	May	6	−5%	0.1	162
	South Africa	Barclays National Bank enters mortgage market at below prime overdraft rate.	June	−24%	78.4	2,601	July	735	+8%	0.4	0
	Tunisia	Sixth five-year plan (1982-86) approved; projects $13.5 billion investment, 6% average annual GNP growth.	Dec.	+6%	8.1	1,240	June	522	+8%	1.7	21
	Zaire	Widespread shortages account for production capacity utilization remaining around 30%.	Dec.	−60%	5.8*	205	June	119	+88%	2.1	423
	Zimbabwe	Weak export demand and drought-reduced maize and cotton crops slow economic growth.	Dec.	−15%	6.7	870	Dec.	230	−3%	2.0	40
Middle East	**Jordan**	New income-tax law aims to boost revenues via higher personal tax ceilings, tighter enforcement.	Dec.	+29%	3.6*	1,127	June	1,007	−18%	4.2	0
	Kuwait	Measures to deal with stock market malaise include recent formation of check clearing house.	May	−30%	24.3	17,350	May	4,170	+7%	6.4	0
	Qatar	Government studying development of the huge North Dome gas field.	May	−33%	5.0*	23,000	Sept.'81	347	−10%	2.3	0
	Saudi Arabia	Domestic oil and gas consumption officially projected to rise three-fold by 1990.	May	−22%	117.6*	14,050	July	30,635	+10%	11.0	0
	United Arab Emirates	Official projects fiscal 1982 federal budget deficit of $1.1 billion—nearly double previous estimates.	May	−21%	29.8	29,780	July	2,967	+13%	3.9	0

*1980

BEST AVAILA

Faster Money Growth Points to Higher Rates

Over the past few weeks most money market rates have backed up by more than 100 basis points in response to the August reacceleration of M1 growth above its upper target bound. Recent money supply data suggest that the Federal Reserve has apparently eased its monetary stance in response to political pressures to bring rates down. The result, however, is likely to be just the opposite.

Proponents of an easier stance contend that an acceleration in the growth rate of the money stock causes interest rates to fall. However, the evidence indicates that heightened money growth in fact leads to higher interest rates, by virtue of its direct positive effect on nominal income as well as an "inflation expectations" effect, which becomes operative when accelerated money growth creates expectations of rising prices in the future. The market builds an inflation premium into the level of interest rates to hedge against declines in the real value of investments.

The misconception that easier money will bring down rates stems from a blurring of the distinction between money and credit. Supporters of this view argue, in effect, that interest rates are the equilibrating force behind the supply of and demand for money; rates must fall to induce people to hold increasing amounts of money. However, it is not interest rates but prices that equilibrate money supply and demand; interest rates, instead, drive the market for credit.

The confusion arises because there is a first-round or "liquidity effect" arising as a byproduct of the money creation process, when monetary expansion places downward pressure on rates. This occurs as the Fed loosens the credit reins by supplying reserves through open-market operations. When the Fed increases its purchases of securities, the supply of loanable funds rises as banks expand their loan portfolios. The effect disappears, however, as aggregate demand increases.

Moreover, recent evidence indicates that this liquidity effect may be exceedingly short-lived, in part because of the Fed's own operating procedures. Weekly movements in the money supply relative to targets often cause rates to move in the same direction, as the market anticipates a change in the Fed's stance in the credit markets. Since the Fed's usage of lagged reserve accounting means the relevant level of required reserves is determined by the level of deposits two weeks earlier, a "passive tightening" occurs if the money supply accelerates. Net borrowed reserves increase, putting upward pressure on short-term rates unless reserves are injected to support the high level of required reserves.

The Fed successfully brought rates down earlier in the summer—but in an environment of weak money growth. In the spring of 1980 the Fed pumped in reserves to drive rates down, only to find them skyrocketing in the wake of a monetary explosion. To again allow excessive money growth can only have the same result.

Robert S. Smith

YMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				exchange rate in U.S. dollars	change from year earlier		
rs	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	September 8, 1982		current monetary conditions	
	Agreements reached on higher prices for Algerian gas.	Dec. '80	+ 10%	Nov.	+ 18%	.2200	− 3%	France to lend $144 million for urban development.	**Algeria**
	Suez Canal revenue officially projected to rise to $1.25 billion by 1983	Feb.	+ 12%	April	+ 33%	1.2200	− 1%	Capital requirements of foreign banks may be raised.	**Egypt**
	Export outlook worsens as coffee-surplus threat foreshadows price weakness.	Feb.	+ 9%	March	− 2%	.00287	− 16%	Foreign exchange shortage severe.	**Ivory Coast**
	Export compensation scheme suspended; export incentives promised.	May	+ 22%	May	+ 11%	.1100	− 11%	Liquidity situation very tight.	**Kenya**
	Restructuring sought for $72 mn. principal and interest owed banks in 1982.	March	+ 2%	May	− 1%	1.1000	+ 3%	Foreign liabilities rise sharply.	**Malawi**
	Exports severely limited by reinstatement of U.S. sugar import quotas.	April	+ 14%	May	0	.0960	− 15%	Domestic credit expansion stagnates.	**Mauritius**
	Phosphate rock was $42.50/ton in second quarter, down 5% from first.	March	+ 15%	Feb.	+ 15%	.1900	− 1%	Domestic credit expanding steadily.	**Morocco**
	Nigeria and Ivory Coast grant each other most-favored-nation status.	Dec.	+ 17%	April	− 4%	.6802	n. a.	Delayed foreign exchange payments starting to move.	**Nigeria**
	Rice imports of over 400,000 tons a year account for 10% of total.	Jan.	+ 7%	March	+ 29%	.00287	− 16%	Credit expands vigorously.	**Senegal**
	Large foreign loan repayments exert pressure on international reserves.	June	+ 16%	May	+ 23%	.8780	− 16%	Rates remain firm.	**South Africa**
	Offshore oil discovery made by a unit of Marathon Oil.	Dec.	+ 10%	April	+ 18%	1.6700	− 16%	Joint investment bank formulating program with UAE.	**Tunisia**
	Foreign exchange shortage caused arrears to rise above $465 mn. at end-'81.	April	+ 31%	Feb.	+ 36%	.1600	− 1%	Credit expansion to government fuels money growth.	**Zaire**
	Pressure mounts for devaluation of currency.	March	+ 13%	April	+ 6%	1.3250	− 12%	Demand deposits on declining trend.	**Zimbabwe**
	Jordanians working abroad officially projected to rise to 303,000 by 1985.	April	+ 9%	Dec.	+ 21%	2.9500	− 1%	Credit generally available.	**Jordan**
	Jan.-June oil output averaged 633,000 b/d—43% below same 1981 period.	Dec.	+ 8%	June	+ 63%	3.4950	− 1%	Bank credit to private sector rising steadily.	**Kuwait**
	Average Jan.-June oil output 340,000 b/d—27% below same 1981 period.	n. a.	n. a.	Sept.'81	+ 17%	.2780	− 1%	Money supply growth rate slows.	**Qatar**
	Aramco Jan.-June output averaged 7.1 million b/d—29% below year earlier.	Jan.	+ 1%	Sept.'81	+ 17%	.2910	− 1%	Riyal weakened relative to the dollar in July.	**Saudi Arabia**
	Abu Dhabi's Jan.-June oil output was 899,000 b/d—24% below year ago.	n. a.	n. a.	April	+ 19%	.2730	0	Money supply growing more slowly.	**United Arab Emirates**

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World Interest Rates

market rates as of Sept. 8, 1982; bond yields as of Sept. 3, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	10.00	13.74	10.625 intervention rate	13.00	9.50	7.00	18.00 penalty rate 21.00	7.00	5.00	5.50
Day-to-Day Money	9.75 September 9	15.50	11.125	11.50	14.125	8.00	18.75	7.625	2.25 1-month Euro-Swiss fr. rate	7.125
Treasury Bills 91-day, Middle Rates	8.23	13.50	10.00	13.50	n. a.	n. a.	16.60 79 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	10.25 finance paper discount basis	14.00 finance paper 15% tax w/h	10.011	12.90 Certified	14.125 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	10.80	13.85 15% tax w/h	10.063	12.90 Certified	not traded	8.50	20.10	no market	4.00	no market
Government Bonds Long-term, new and old issues, average yield	12.16	14.35	11.03	9.958 20% tax w/h	15.46	8.75	19.11	6.94	4.64	8.112
Industrial Bonds prime, long-term, new and old issues, average yield	14.35 Aa Industrials	15.25	12.55	14.628	16.32	8.77	19.75	10.88	6.03	6.64
Bank Short-Term Rate to Best Borrowers (prime rate)	13.50	15.50	11.50	16.75	16.05	11.50	20.75 ⅛ qtrly fee on outstdng.	9.50	8.50	6.00
Bank Time Deposits 3-month	10.25 Cert. of Dep.	13.00	10.625	13.25	14.125	8.05	11.50	8.25 large deposits	3.50 residents only	3.75
Eurocurrencies 3-month, asked	11.50	14.25	10.875	no market	21.00	7.875	no market	7.8125	3.8125	7.4375
Exchange Rates—in U.S.$ rates floating against the $	—	.8117	1.7240	.0210	.1418	.4024	.000715	.3673	.4723	.003866
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.50 *D*	1.00 *D*	1.00 *D*	9.00 *D*	3.50 *P*	9.50 *D*	3.50 *P*	7.50 *P*	4.00 *P*

Eurodollar Deposits

(London, interbank, bid)

September 9

7-day	10.313
1-month	10.813
3-month	11.438
6-month	12.438

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−0.633
U.S.-Canada Treasury Bills	−2.151
U.S.-Canada Finance Co. Paper	−1.058
Eurodollars-U.K. Local Auth. Deposits	+1.688

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	13.625
Over 7 yrs.	14.00
DM Bonds	
7 yrs. and under	9.125
Over 7 yrs.	9.00

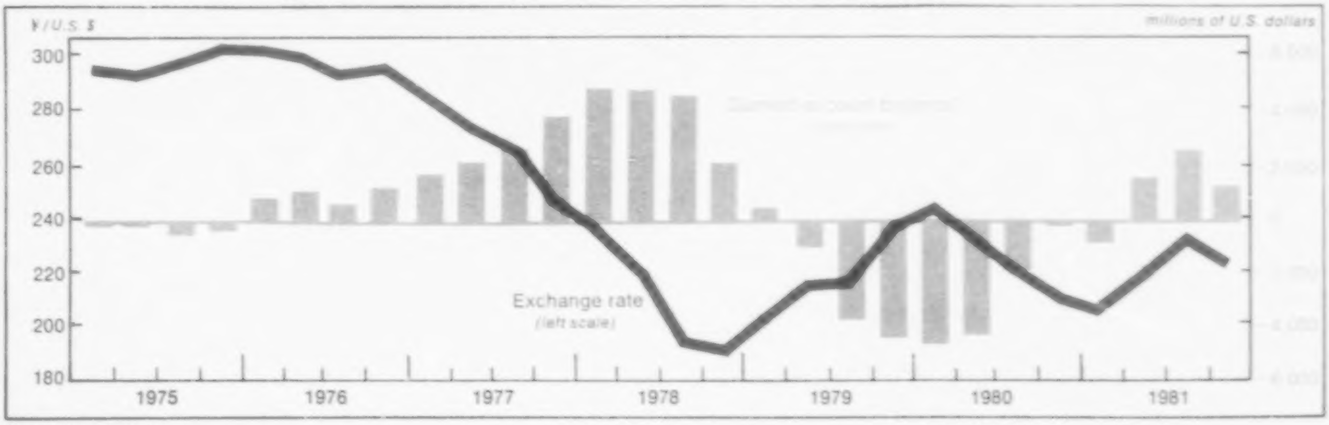
Gold Price

London
afternoon fixing

461.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

The yen/dollar exchange rate and Japan's current account



*Seasonally adjusted

Japan's Changing Financial Markets

(Second of a three-part series)

Since the early 1970s, the Japanese financial system has undergone substantial structural changes in response to a number of internal and external developments. These changes, combined with the liberalization of Japan's foreign trade and exchange laws, have had far-reaching effects on both Japanese monetary policy and the behavior of the yen.

As noted in the first article of this series, during the early post-war period the Bank of Japan (BOJ) was able to control the domestic money supply by directly regulating credit to the private sector, since budget deficits and hence credit expansion to the government were relatively minor and since strict foreign exchange regulations kept changes in net foreign assets under control. The "dollar crisis" of the early 1970s, however, led to an enormous inflow of international reserves. And with the BOJ largely unable to offset the effects on the domestic money supply because of its limited open market operations, money growth soared and inflation accelerated. In February 1973, the government of Japan finally abandoned its fixed exchange rate system and adopted a managed floating exchange rate regime in order to be able to control the effect of reserve flows on the domestic money stock.

The first oil shock of 1973-74 also had a profound effect on the Japanese financial system. The growth of Japanese industry slowed dramatically as firms adjusted to the steep jump in oil prices. Consequently, business' strong demand for funds for investment subsided. Moreover, companies were increasingly able to generate needed funds internally, reducing their dependence on the banks for financing.

As the demand for funds by the corporate sector waned, the demand for funds by the public sector mushroomed. Government deficits began to rise sharply in fiscal 1975, as policymakers attempted to spur growth through increased spending—mainly for public works. To finance the deficits, the government issued large quantities of bonds. To a large extent, these were forced on the banks at below-market yields in order to control debt financing costs. As a result, the contribution made to the domestic money supply by net credit expansion to the government soared.

With banks less dependent on the BOJ for funds, firms less dependent on the banks for financing, and net credit to the government contributing more and more to increases in the domestic money supply, the central bank was no longer able to control the domestic money stock through direct controls on credit to the private sector. As a result, the BOJ shifted in the mid 1970s to a money-supply target and began to use open market operations as its primary tool of monetary policy. At the same time, the monetary authorities took steps to increase the use of interest rates to regulate the quantity of funds supplied and demanded.

The new foreign exchange law

Perhaps the most significant developments recently in the Japanese financial system have resulted from the New Foreign Exchange and Foreign Trade Control Law, which went into effect on December 1, 1980. Although great strides had been made in liberalizing exchange controls prior to the new law, all overseas transactions still were prohibited in principle and required official approval. According to the new law, however, all external transactions in trade, foreign exchange, and capital are now technically free, unless specified otherwise. Four types of transactions that had not been fully liberalized previously are affected:

- Japanese residents now have unlimited freedom to change yen into foreign currency for deposit with Japanese foreign exchange banks, whereas previously there had been a ¥3 million limit;
- Japanese banks are now free to borrow and lend foreign currencies at home and abroad without restrictions—at least in principle;
- Japanese companies have greater freedom to borrow abroad; and
- The scope for foreign investment in Japan has been widened, particularly in the area of equities.

Although, in essence, all international transactions are free under the new law, the monetary authorities do continue to exert some control through administrative guidance. For example, the monetary authorities limit "samurai" bond issues (yen-denominated bonds floated by foreigners) as well as banks' yen-denominated and foreign-currency syndicated loans. The monetary authorities have also reserved the right under the law to impose formal restrictions in case of an emergency, such as excessive exchange rate fluctuations, balance of payments deficits, or massive capital movements that adversely affect the money markets.

This liberalization of capital flows has important implications both for the structure of the Japanese financial system and for the conduct of monetary policy in Japan. By increasing the menu of financial assets available to the Japanese investor, the new foreign exchange law is likely to contribute significantly to the liberalization of Japanese interest rates. Specifically, the decontrol of domestic deposit rates may be hastened, since interest rates on yen deposits are still controlled by law, while rates on foreign currency deposits are allowed to fluctuate in line with prevailing Eurodollar rates. In addition, by opening up addi-

Japan's Changing Financial Markets *(continued from page 7)*

tional avenues for the banks and firms to raise funds, the new law further reduces the dependence of firms on the banks and the dependence of the banks on the BOJ. This then dampens the effectiveness of the traditional tools of monetary policy even more. Window guidance, in particular, is now much less effective in times of monetary restraint, since firms can circumvent the lending ceilings by borrowing abroad.

Furthermore, the lifting of capital controls has resulted in interest-rate arbitrage between domestic and foreign securities. As a consequence, Japanese capital flows have become quite sensitive to changes in interest-rate differentials and to changes in exchange rate expectations. Thus, the Japanese monetary authorities are finding it increasingly difficult to control domestic interest rates and to insulate the domestic economy from foreign developments. This has been particularly evident over the last year as high real interest rates in the United States have put upward pressure on rates in Japan. Moreover, by opening up an additional avenue through which an excess supply or demand for money can be dissipated, the relaxation of capital controls has also made it harder for the BOJ to control the domestic money supply, to the extent that the exchange rate is not freely floating. To exert some influence in such an environment, the BOJ must allow its policy changes to be reflected in interest rates.

The new discount mechanism announced in March 1981 seemed to be a signal that the Japanese monetary authorities increasingly would use interest rates, rather than quantitative controls, to affect capital flows. Under the new system, central bank loans to banks are to be made at a rate higher than the discount rate when the BOJ wants to induce an increase in domestic interest rates in order to stem an outflow of capital. The new system has yet to be used, however, and earlier this year, the Japanese authorities reverted to direct controls to moderate capital flows because of the weakness of the yen.

Implications for the yen

Provided that the Japanese monetary authorities do not intervene more extensively to control capital flows, the liberalization of capital flows also has important implications for the behavior of the yen. Until 1979, the behavior of the yen/dollar exchange rate mirrored closely the behavior of the current account (see chart on page 6); in general, the yen appreciated as the current account improved and depreciated as the current account deteriorated. Because capital movements were closely controlled by the monetary authorities, the current account was virtually the only avenue through which stock disequilibrium in the money market could be eliminated—other than through changes in the domestic price level or real output. For example, an excess supply of money in the economy could be dissipated through increased purchases of domestic goods—causing an increase in either real output or the domestic price level—or through increased purchases of foreign goods. The latter would cause a deterioration in the current account and, depending on the degree to which the monetary authorities intervened, a loss of reserves or depreciation of the exchange rate. Thus, although the exchange rate was influenced by monetary phenomena, it closely mirrored the behavior of the current account, since both reflected the same stock disequilibrium in the money market. The extent to which this disequilibrium was actually eliminated through the current account was dependent, of course, on the degree to which Japan's goods and services markets were relatively open—a topic still widely debated.

With the liberalization of capital flows under the new foreign exchange law, however, stock disequilibrium in the money market can now be eliminated through a combination of current- *and capital-account* adjustments. As a result, there need not be any particular relationship between changes in the current account balance and changes in the exchange rate, since monetary phenomena can now be reflected in the capital account. Instead, the overall balance—that is, the change in reserves—and changes in the exchange rate will be related, because both reflect an excess demand or supply of money. For example, an excess supply of money in the economy can be dissipated through the domestic channel, as mentioned earlier, or through increased purchases of foreign goods *and securities*. This will cause a deterioration in the overall balance (sum of current and capital accounts) and, depending on the degree to which the monetary authorities intervene, a loss of reserves or depreciation of the exchange rate.

Presumably there is still likely to be a reasonably high correlation between changes in the current account balance and changes in the exchange rate, since stock disequilibrium in the money market is likely to be reflected in purchases of foreign goods as well as securities. But economists who base their forecasts of the yen on the outlook for the current account could be misled. As a case in point, in 1981 the rate of growth in broad money, at 11 percent, was far in excess of the growth in nominal income of 5.8 percent, suggesting that there was likely to be an excess supply of money in the economy. Yet despite a sharp improvement in the current account—from a deficit of $10.7 billion in 1980 to a surplus of $4.7 billion in 1981—the yen remained very weak, averaging 220.53 yen per dollar in 1981 against 226.75 in 1980. This was because the excess supply of money was dissipated largely through the capital account.

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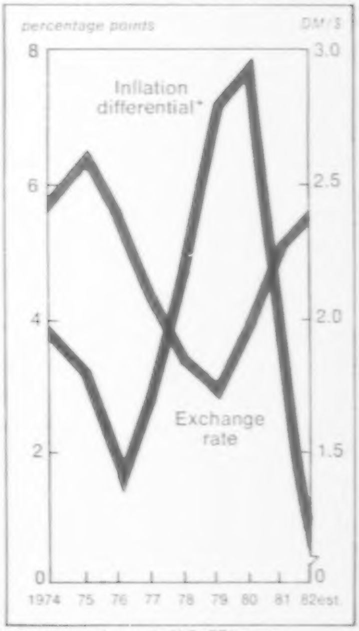
U.S. Unlikely to Lead Worldwide Reflation

Concerned that continued disinflation will intensify the current recession, leading to a further battering of the international financial system and greater unemployment and social unrest, a number of world leaders have called for a global shift to reflationary policies—led by the United States. The suggestion that the United States act as a "locomotive" to pull the rest of the world out of recession, as it did in the late 1970s, is certainly not new. But heretofore, U.S. authorities have firmly rejected such a strategy out of hand. Some analysts are now suggesting, however, that the Federal Reserve is changing its stance. They cite the recent decline in U.S. interest rates as proof that America is getting ready to reflate and may have even already begun the process.

Relative U.S. inflation and the value of the dollar



*percentage change in U.S. CPI minus percentage change in German CPI

Despite its political attractiveness, most other industrial countries have shied away from the reflation alternative because the cost to go it alone would be huge. The exchange markets are unforgiving to countries that attempt to run a divergent monetary policy and quickly pass judgment on what are perceived as inflationary actions. This is a lesson the United States learned during the last major expansion and one the Europeans and Japanese have had to relearn over the past two years. As long as it was apparent that the United States was holding fast to its anti-inflationary policies, most other countries rejected the reflationary route; to reflate without the U.S. locomotive has been deemed impossible. The question that now arises is whether the exchange markets agree with those domestic observers who assert the Fed is loosening its grip and beginning what could become "the great reflation of 1982."

So far, the exchange markets apparently do not think this is the case. The late-summer decline in U.S. interest rates has been met with dollar strength, rather than weakness. If anything, these markets are suggesting that the U.S. resolve to sustain a disinflationary policy is stronger than that of its major trading partners and that any shift toward reflation is likely to begin not with the United States but with Europe and Japan. Whether reflation is the "correct" policy is not important to the determination of exchange rates. The probability that a country will or will not reflate, however, is critical. For now, the markets are betting that the United States will be a caboose—not a locomotive—in any move toward reflation.

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British interest rates unlikely to fall further despite continuing slump.

Contrary to official forecasts that the British economy would show an early upturn, recent statistics indicate it remains firmly in recession. Industrial production turned sluggish over the summer, compared with earlier in the year. And retail sales, although about 1.5% above 1981's levels, have been satisfied as much by imports as by domestic manufactures. As a result, unemployment has continued to climb steadily, reaching 12.5% in August, and is set to rise still further. With the next election in mind, the government has shifted its policy toward giving some boost to the economy by means of reduced interest rates. Banks' base rates, which stood at 13% at the end of May, have fallen steadily to 10.5% at present. But interest rates elsewhere have also declined; thus, sterling has strengthened a little since May. The market has hopes for further reductions in interest rates. However, there are signs that the money supply is beginning to expand more rapidly, and this may prevent further declines over the near term. In addition, a strong pound remains an important part of the government's anti-inflation policy and, unless interest rates fall again elsewhere in the world, the scope for a unilateral decline of British rates may be limited.

Greek economy may force policy retrenchment in 1983.

The Greek economy continues in recession. Industrial output in the March-May period slumped some 2% below its year-earlier level, and 1982 real GNP growth is expected to be 1% at most. At the same time, the rate of inflation—measured in year-on-year terms—after falling to a low of 19.6% in February, rose to almost 23% by June, in part as a result of increases in indirect taxes imposed in the 1982 budget. Data for the first five months of the year show that the current-account deficit declined by about $379 million to $968 million. This improvement is attributable to a fall in Greece's net oil imports, partly owing to a drawdown of inventories. Non-oil exports fell while imports rose, raising the non-oil trade deficit by some $260 million in the first four months of this year. Furthermore, private capital inflows are down significantly from year-earlier levels, and the rapid rates of growth of money and credit—estimated at over 30% per annum—indicate an acceleration in the rate of inflation. These trends in turn suggest that the authorities may well adopt a less expansionary policy stance in 1983.

Brazil boosts bank reserve requirements.

In the interest of dampening import demand and easing inflationary pressures, Brazilian monetary authorities have increased reserve requirements to help contain money growth. Reserves for demand deposits have been raised to 45% from 35%, and a new 5% reserve requirement for time deposits has been instituted. Demand-deposit reserves are non-interest bearing, but the reserve requirement on time deposits may be satisfied by purchasing indexed treasury bonds. The purpose of these measures is to slow the growth of the monetary base, given the expansion of subsidized agriculutural and export credits. To be sure, achieving a strong trade surplus and stemming an inflation rate that was running at a 97.7% annual rate in August are important goals for Brazil. But the monetary measures will also mean higher interest rates and a further restraint of overall economic activity, which has been quite slow during 1982.

Indonesian development plans threatened by precipitous drop in oil revenues.

Indonesia's oil revenues have plummeted as oil prices and sales have weakened worldwide. For the period January through July, revenues were only $6.36 billion—a drop of 36.5% from the oil revenues enjoyed during the same period in 1981. The fall is attributable in part to the OPEC-imposed quota of 1.3 million barrels per day, well below Indonesia's capacity of 1.64 million b/d. The other problem is soft prices owing to slack demand now that Japan, Indonesia's biggest customer, is experiencing an economic slump. The government has resisted a price cut designed to stimulate sluggish sales. However, a sizable reduction will be needed to close the price gap that exists between Indonesian and comparable Saudi Arabian crudes. Indonesia derives some 70% of its overall export revenues from oil sales. Unless a rebound occurs soon, the government may be forced to scale back some of its ambitious development plans.

Current-account gap for Philippines expected to widen.

Because of the continued weakness of the world economy and the depression in commodity prices, the outlook for the Philippine balance of payments in 1982 remains grim. Non-traditional manufactured exports rose 17.6% in the first half from a year earlier, but total exports fell 9.9% because of continued low prices for coconut oil, sugar, copper, and other commodities. The weakness of the domestic economy held the increase in imports to just 3.1%. Still, the current-account deficit widened to $1.43 billion from $840 million a year earlier. In the past, trade figures for the first half of the year have not been very reliable indicators of final year-end results. Nevertheless, there seems little prospect for any improvement in the second half. Commodity prices show no signs of revival, and exports of manufactured goods may now be flagging because of increased labor troubles at home and greater protectionism abroad, particularly in Europe. Thus, for 1982 as a whole, the Philippine current-account deficit could widen to perhaps $3.2 billion from $2.3 billion in 1981.

Marked contraction in Saudi Arabian current-account surplus forecast.

Most of Saudi Arabia's current-account surplus—which reached a record $42.5 billion dollars in 1981—is expected to disappear this year because of sharp oil production cutbacks to defend the $34-per-barrel "benchmark" price of Saudi light crude. The surplus had widened last year from around $40 billion in 1980, despite a 19% increase in imports of goods and services plus transfer payments. This was largely due to a 12.5% rise in the average price of Saudi oil to $32.25 per barrel that boosted gross oil revenues to $111 billion (on an accrual basis) in spite of a small dip in oil output to 9.8 million b/d. So far this year, however, Saudi Arabia's oil production has fallen sharply; total production for 1982 is not likely to average much more than 7 million b/d. Consequently, even if oil prices remain unchanged during the remainder of the year, gross oil income is projected to drop 27% to $81 billion. Thus, even if payments for imports and transfers expand by a relatively modest 10% to $91 billion, the country appears likely to register a current-account surplus of no more than $6 billion in 1982.

Financial constraints confront new plan for Syrian economy.

Although Syria has only recently published its relatively ambitious Fourth Five-Year Plan (1981-85), the economy already appears to be facing financial constraints. Neither of the country's two major sources of foreign exchange this year is likely to attain 1981 levels. First, oil revenues appear to be declining because of lower prices, despite steady output (180,000 barrels per day). Syrian oil now sells for $30 per barrel as against a peak of $36 in December 1980. The fall in net oil income, however, has been mitigated by an agreement to import lower-cost Iranian oil. Second, receipts of Arab aid grants are believed to be down. The Kuwaiti Assembly voted to suspend payments to the Arab Peacekeeping Force in February 1982 and other payments were reported to have been delayed, although they are now believed to have been restored. Already the financial shortfalls are having an impact: In May all budget allocations were cut by 10% and a parallel exchange rate was established at 5.70 Syrian pounds per U.S. dollar.

Copper-market revival awaits rebound of industrial economies.

Sagging demand, weak prices, and higher operating costs have forced a rash of copper mine closings in the United States and Canada in recent months. Continued recession in the U.S. auto and housing industries has contributed to the steady decline in world copper prices to around 70¢/lb.—down by more than 22% from the already depressed levels of January 1981. At the same time, however, average break-even production costs are up by 35%, ranging from about $1.20/lb. in the United States to around 75¢/lb. among the LDC producers. The developing nations are hoping to increase copper output by some 20% in 1982 in order to meet their foreign currency requirements, and this should help to offset the U.S. cutbacks. Overall, net world production in 1982 is expected to be unchanged at about 7 million tons for the fourth year in a row. High carrying costs and low levels of business activity have kept both producer and consumer inventories at low levels. Consequently, any increases in demand will be quickly translated into higher prices over the short run.

An Interest-Rate Target for the Fed?

Bills introduced recently in the Senate and the House relating to the conduct of monetary policy have been gaining increasing attention. In essence, the proposed legislation would add an interest-rate objective to the monetary and credit aggregates now stipulated as intermediate policy targets in the Federal Reserve Act. There does not seem to be much likelihood that such a measure will be enacted during the final days of the current Congress. Nevertheless, high rates have been a major element in the economy's weakness, and further pressures to "do something" about rates will probably emerge when the new Congress convenes next January.

While both bills would require the setting of an interest-rate target, there are differences in detail. The version introduced in the House of Representatives would mandate that the Federal Reserve add long-term interest rates to its present list of targets (M1, M2, M3, and bank credit). The Senate bill is somewhat more complex. It would entail the targeting of *real* short-term interest rates—that is, rates adjusted for inflation. Moreover, rather than simply adding another target variable, this version could give rates a relatively greater policy role by requiring that money and credit targets be consistent with that for interest rates.

Fundamentally, of course, price and quantity cannot *both* be controlled. To attempt to do so, as the Federal Reserve has at times, virtually insures that neither objective will be met. Beyond this, however, at least part of the unease over monetary policy—and over the interest-rate levels to which it has contributed—has reflected concerns with what the Fed is attempting to control. Specifically, there have been serious difficulties with measuring and interpreting the aggregates—particularly M1. Over the first eight months of 1982, for example, NOW accounts (interest-bearing consumer checking accounts) constituted 92% of the total expansion of M1. As currently measured, M1 has been at or above its upper target level for virtually the whole year. A portion of the NOW account growth undoubtedly performs the function of a non-transaction holding (which would not be included in M1), although how much is open to question. Nevertheless, a better measure of the growth of "true" transactions funds—or a different target—could have meant less monetary stringency during 1982 and lower interest rates.

The elimination of restrictions on deposit pricing—ceilings, minimum maturities, minimum denominations, and sterile reserves—would substantially reduce incentives for the development of new instruments to act as substitutes for those subject to regulatory constraints. Unfortunately, there appears to be little prospect for the necessary legislative action in the foreseeable future.

Richard C. Aspinwall

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1981		BALANCE OF P				
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use of IM credit, millions of doll
Austria	Both domestic and foreign orders declining; 1982 real GNP forecast revised down to 1.5%.	Jan.	+ 6%	65.8	−0.1%	July	4,539	+ 1%	2.7	3
Belgium	Under continuing austerity program, budget deficit to be reduced to 10.5% of GNP in 1983 from 11.4%.	April	+ 3%	96.1	+2.0%*	July	3,731	−35%	0.7	3
Britain	Production remains flat; unemployment expected to rise further.	July	+ 1%	523.0*	−1.9%*	July	13,143	−17%	1.5	113
Denmark	Economy continues to grow at moderate pace.	May	−14%	55.9	−0.2%	July	1,973	−31%	1.3	0
Finland	Activity continues to slow but 1982's GDP will still post an increase over last year.	April	− 2%	47.8	+1.0%	July	1,145	−26%	1.0	31
France	Budget proposals for 1983 underline less expansionary economic policy.	June	− 1%	657.0*	+1.6%*	June	15,178	−40%	1.5	0
Germany	Both industrial orders and production decline sharply; official forecasts for real growth revised downward.	July	− 6%	689.4	−0.3%	July	40,992	−14%	3.0	0
Greece	Output remains flat, but inflation set to rise.	May	− 5%	37.7	+1.6%*	May	828	+ 5%	0.9	4
Ireland	Tough policies now being reflected in falling production index.	May	+ 1%	17.6*	+1.9%*	July	2,669	+21%	3.0	0
Italy	Economy remains flat; fiscal policy tightened in response to rapidly rising public-sector deficit.	June	− 3%	350.6	−0.2%	July	15,355	−14%	1.9	0
Netherlands	Negotiations expected among major parties on formation of coalition govt. following recent election.	May	− 2%	139.0	−1.1%	July	8,286	− 8%	1.7	0
Norway	Reduced oil production will lead to a 1% fall in GNP relative to 1981.	June	− 2%	55.6	+0.8%	July	6,652	+21%	5.0	0
Portugal	Constitutional revision could bolster private sector.	Jan.	+ 7%	23.5*	+5.5%*	June	488	−15%	0.6	19
Spain	Economic outlook uncertain owing to upcoming election on October 28.	March	+ 3%	213.1*	+1.2%*	May	8,948	−10%	3.3	70
Sweden	Some growth is expected for 1982 but the economy is slowing.	May	− 1%	111.6	−0.8%	July	3,243	−11%	1.4	0
Switzerland	Real GDP may fall 1%-2% this year.	March	0 **	97.8	+1.4%	July	12,320	+20%	5.0	0
Canada	Worst recession in post-war era continues; August unemployment was 12.2%.	June	−14%	274.0	+3.0%	Aug.	3,092	+25%	0.5	0
United States	Economic recovery delayed by sluggish consumer spending despite July 1 tax cut.	Aug.	−10%	2,937.7	+1.9%	July	20,078	+13%	0.9	0

* 1980 ** 4th quarter average over 4th quarter average

BE

Wage Gains Decelerate

Bad news about rising unemployment in the United States has overshadowed the good news about lessened inflationary pressures from smaller increases in earnings. Unemployment increased to 9.8% in August from 7.4% just one year ago and there are indications that the unemployment rate will move above 10% in the coming months. Meanwhile, however, the year-over-year average gain in hourly wages fell to 6.6% in July (latest data), the first dip below 7% since early 1970s. Last summer, wages were increasing at a pace of more than 9%. Such a slowdown, if continued, will not only help the prospects for a lasting improvement in inflation but also pave the way for recovery.

There are three major influences on wage-setting patterns: the level of unemployment, actual and expected inflation, and the extent of unionization. In general, when unemployment is high, lower inflation and declining unionization mean the rate of wage increase will be lower. Current inflation as measured by the CPI has been cut nearly in half since 1980. At the same time, employment in the less-unionized sectors of the economy has grown significantly faster than in those sectors covered by collective bargaining agreements, while overall unemployment has continued to climb. Thus, an eventual slowing of wage gains was expected.

The moderation of wage increases has been very uneven, however. For example, the two major categories that have had the slowest rate of wage increases are wholesale-retail trade and contract construction. Although unemployment in the trade sector is not higher than average, its level of unionization is far below average. Conversely, the construction industry is relatively heavily unionized, but it is experiencing more than 20% unemployment. In fact, with this depression-level unemployment, it is somewhat surprising that wage gains in the construction industry are as high as they are.

These general influences not only affect wage gains in other industries but hold for occupational groups as well. Wage increases for largely non-union white-collar office workers, whose unemployment has increased only about one percentage point in the past year, have fallen just one-half percentage point. Wages of heavily unionized blue-collar workers, who have experienced the sharpest rise in unemployment (from 9.5% to 14.2%), have slowed about one-and-a-half percentage points. And service workers, mostly unrepresented by unions, have had only a slight rise in joblessness while their wage gains have slowed by nearly two percentage points.

The outlook for wage increases for the next year or so is for continued moderation. Inflation is likely to fall further, and any economic recovery that takes hold is unlikely to be strong enough to lower the unemployment rate significantly. Thus, average wage increases are likely to fall below 6% by the middle of next year.

Douglas L. Bendt

MENTS	MONEY AND BANKING							
	12-month changes							
s current influences on payments	latest data	consumer prices	latest data	money supply(M1)	central bank rate△	exchange rate in U.S. dollars Sept. 22, 1982	current monetary conditions	COUNTRIES
Jan.-July current-account surplus was 3.5 bn. sch., major reversal from year ago.	July	+ 6%	June	+ 4%	6.75%	.05695	Discount and Lombard rates reduced by 0.5 percentage pt.	**Austria**
Devaluation improves competitiveness of Belgian goods, reducing trade deficit.	July	+ 9%	March	+ 3%	17.50%	.0208	Interest rates eased.	**Belgium**
First half 1982 showed a £1.2 billion surplus, vs. £4.7 billion year ago.	Aug.	+ 8%	June	+ 14%	10.63%	1.7175	Interest rates down sharply since June.	**Britain**
First half 1982 current-account deficit was kr 10.72 bn., vs. kr 5.84 bn. in '81.	June	+ 9%	Feb.	+ 13%	11.00%	.1143	Kroner speculation preventing interest-rate decline.	**Denmark**
Current-account surplus of fmk 482 million in the first half of 1982.	July	+ 10%	May	+ 20%	8.50%	.2083	Current anti-inflationary stance expected to continue.	**Finland**
Current-account deficit of around FF 50 billion expected in 1982.	Aug.	+ 11%	April	+ 16%	9.50%	.1419	Less speculation against FF may allow interest-rate cuts.	**France**
Current account continues to improve on shift in terms of trade.	Aug.	+ 5%	June	+ 4%	7.00%	.4008	Lombard and discount rates reduced.	**Germany**
Lower oil bill reduces current-account deficit.	June	+ 23%	Dec.	+ 22%	20.50%	.0158	Money and credit continue to expand rapidly.	**Greece**
Trade deficit was £729.9 million over Jan.-July, vs. £1.1 billion year ago.	May	+ 21%	June	+ 6%	17.50%	1.3700	Prime rate down to 16% from 19% in August.	**Ireland**
Jan.-June trade deficit was 9.9 trillion lira, vs. 10.9 trillion year earlier.	Aug.	+ 17%	March	+ 7%	18.00%	.000711	Discount and prime rates reduced by 1 percentage pt.	**Italy**
Current account remains in surplus; natural gas exports may be raised.	June	+ 6%	May	+ 3%	7.00%	.3666	Interest rates fall in line with German rates.	**Netherlands**
Current account still in surplus but sharply reduced owing to falling oil revenues.	July	+ 11%	April	+ 9%	9.00%	.1443	Relatively high inflation again forces 3% kroner devaluation.	**Norway**
1982 current-account deficit forecast to exceed $2 billion.	May	+ 25%	Dec.	+ 9%	19.00%	.0120	Inflation still above 25%.	**Portugal**
Jan.-June current-account deficit was $3.2 billion, vs. $4.1 billion year ago.	May	+ 15%	May	+ 16%	8.00%	.00889	M3 growth rose to 17.4% in June.	**Spain**
Jan.-June current-account deficit was kr 5.1 billion, vs. kr 4.3 billion year ago.	July	+ 8%	March	+ 9%	10.00%	.1606	Monetary policy remains restrictive after July tightening.	**Sweden**
Export volume contracting.	Aug.	+ 5%	May	− 1%	5.00%	.4678	Central bank easing has led to pick-up in money growth.	**Switzerland**
Credit line available to boost C$ expanded by $2 billion.	Aug.	+ 11%	April	0	13.42%	.8150	Money remains tight; M1 virtually unchanged this year.	**Canada**
Exports held down by continuing world recession.	Aug	+ 6%	Aug.	+ 6%	10.00%	—	Money growth accelerates; rising interest rates feared.	**United States**

△most recently reported.

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World Interest Rates

market rates as of Sept. 22, 1982; bond yields as of Sept. 17, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	10.00	13.42	10.625 intervention rate	12.50	9.50	7.00	18.00 penalty rate 21.00	7.00	5.00	5.50
Day-to-Day Money	10.25 September 23	15.50	11.00	11.95	14.125	8.00	18.50	7.75	7.25 1-month Euro Swiss fr. rate	6.9375
Treasury Bills 91-day, Middle Rates	7.37	12.90	10.25	12.75	n. a.	n. a.	16.503 79 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	10.50 finance paper discount basis	13.25 finance paper 15% tax w/h	10.011	12.40 Certified	14.3125 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	10.30	13.00 15% tax w/h	10.125	12.40 Certified	not traded	8.50	21.00	no market	4.25	no market
Government Bonds Long-term, new and old issues, average yield	12.04	13.95	11.23	9.944 20% tax w/h	15.66	8.65	19.20	9.93	4.47	8.15
Industrial Bonds prime, long-term, new and old issues, average yield	13.85 Aa Industrials	14.75	12.72	15.20	16.34	8.69	19.83	10.82	5.87	6.66
Bank Short-Term Rate to Best Borrowers (prime rate)	13.50	15.50	11.50	16.25	16.05	11.50	20.75 ½ qtrly fee on outstdng.	9.50	8.00	6.00
Bank Time Deposits 3-month	10.125 Cert. of Dep.	12.85	10.6875	12.60	14.375	8.15	11.50	8.00 large deposits	3.25 residents only	3.75
Eurocurrencies 3-month, asked	11.75	13.00	11.00	no market	19.25	7.625	no market	7.875	4.1875	7.4325
Exchange Rates—in U.S.$ rates floating against the $	—	.8150	1.7175	.0208	.1419	.4008	.000711	.3666	.4678	.00381
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.50 *D*	1.00 *P*	1.25 *D*	8.00 *D*	4.00 *P*	8.50 *D*	3.75 *P*	7.375 *P*	4.375 *P*

Eurodollar Deposits
(London, interbank, bid)
September 23

7-day	10.5625
1-month	10.9375
3-month	11.5625
6-month	12.3125

International Arbitrage
(3-month, hedged)
+ *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−3.739
U.S.-Canada Treasury Bills	−3.457
U.S.-Canada Finance Co. Paper	−1.068
Eurodollars-U.K. Local Auth. Deposits	+0.125

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	12.375
Over 7 yrs.	13.00
DM Bonds	
7 yrs. and under	8.625
Over 7 yrs.	8.875

Gold Price
London
afternoon fixing

443.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Aug.) 5.9	(Aug.) 10.6	(Aug.) 8.0	(Aug.) 10.9	(Aug.) 5.1	(Aug.) 17.2	(Aug.) 5.2	(July) 1.7
Industrial production*	(Aug.) −10.2	(June) −14.0	(July) 0.6	(June) −0.8	(July) −5.6	(June) −3.0	(March) 0	(July) 0.7
Trade balance† *(billions of local currency units)*	(July) −$2.42	(July) C$1.56	(July) £0.17	(Aug.) −FF8.98	(July) DM3.70	(July) −Lit.730	(Aug.) −SF0.78	(July) ¥594
Money supply (M1)*	(Aug.) 5.6	(April) 0.3	(June) 13.5	(April) 15.5	(June) 4.0	(March) 7.3	(May) −0.9	(May) 6.6
Velocity of money (M1)*	(June) −0.4	(Dec.) 17.7	(Dec.) −5.9	(Dec.) 0**	(March) 3.1	(Dec.) 7.6**	n. a.	(March) −4.5
Reserves minus gold *($ million, change from previous month)*	(July) 560	(July) 344	(July) 239	(June) −597	(July) −811	(July) 1.030	(July) −1,015	(July) 183

* Percent change from 12 months earlier.

**based on GDP

† Figures are only for the month indicated.

Japan's Changing Financial Markets

(Last of a three-part series)

Despite radical changes over the past decade, the transition of Japan's financial system, in response to extraordinary developments in Japanese foreign and domestic economic policy, is in many respects just beginning. How the system evolves over the next several years will depend primarily on how fast and to what extent restrictions on Japanese interest rates are eliminated.

At present, the huge volume of new debt the government must issue to finance its growing deficit represents the biggest stumbling block to the emergence of a truly free financial market—in which interest rates are determined by the demand and supply of funds. Policymakers are strongly resisting attempts to liberalize the terms of new bond issues, as such a move would inevitably mean a sharp increase in the interest burden of servicing the government debt. And yet, underwriting syndicates have become increasingly reluctant to accept new government issues at existing below-market terms. Over the past year in particular, high U.S. interest rates have pulled up secondary market yields, leaving underwriters highly vulnerable to onerous capital losses if they are subsequently forced to sell the bonds. As a result, the government's difficulty in selling bonds is putting severe pressure on policymakers to slash expenditures in order to reduce the volume of bonds needed for deficit financing. And it is also providing the impetus for a number of further changes in the Japanese financial system.

For example, Japan enacted a new banking law last April that, effectively, will help to expand the market for government bonds. Under the so-called "Amended Banking Law," banks will be permitted to sell newly issued national bonds to the public at teller windows beginning April 1, 1983. Banks hope that the bonds can be sold over the counter at a price closer to the purchase price, because issuing rates will be higher than the rates available on savings deposits. Additional changes are actually likely to occur rather rapidly, since in fiscal 1985 the government will have to start rolling over the large amounts of debt incurred in recent years. At a minimum, banks are expected to be allowed to sell old issues of government bonds.

Changes are taking place in the shorter end of the market, as well. The Bank of Japan's (BOJ) recent sales of short-term government bills at market rates, in order to soak up seasonal surpluses of funds, may well lead to the development of a full-fledged secondary bill market—and to increased pressure on the government to auction the bills at market rates.

The freeing up of interest rates will also encourage the development of Japan's private capital markets, allowing direct business financing to take on increasing importance. Moreover, pressures for the development of a domestic commercial-paper market are expected to intensify once banks and securities firms receive permission to deal domestically in commercial paper issued abroad. As new avenues open up through which firms and banks can raise funds, the traditional dependence of firms on the banks and of banks on the BOJ will diminish even further. In addition, liberalizing the market for government securities will lead to pressures for the decontrol of deposit interest rates, as government bonds are forced to compete with savings deposits. As in the United States, however, reforms in deposit rates are likely to come about slowly.

As liberalization occurs, competition among banks and between banks and other types of financial institutions is expected to intensify. And this is likely to lead to the development of new financial products. The Amended Banking Law has already stepped up the competition by allowing banks to deal in national bonds and eventually, along with securities firms, to sell foreign certificates of deposit and commercial paper in Japan.

The internationalization of the yen

Finally, the liberalization of Japanese financial markets and capital flows is likely to promote the use of the yen as an international currency. Use of the yen for the settlement of trade transactions has grown steadily over the past decade, with the share of Japanese exports denominated in yen jumping from 2% in the early 1970s to over 30% today. However, the proportion of Japanese imports denominated in yen—which is far more crucial to the development of the yen as an international currency—has remained at only 2%-3%, partly for lack of a market for bankers' acceptances.

At the same time, the yen's role in financial transactions has grown as the liberalization of capital flows has led to increased foreign investment in Japan. As government constraints on the Japanese financial markets continue to be lifted and as the menu of yen-denominated financial instruments grows, the internationalization of the yen will increase further. The creation of an offshore banking center in Tokyo, currently under government consideration, would accelerate this process. Still, the yen's role in fiancial transactions is likely to remain limited as long as the BOJ places ceilings on samurai bond issues and on banks' yen-denomiated foreign lending.

The Japanese financial system has a long way to go before it can be considered open and market-oriented. However, the changes that have occurred over the last decade and those that are likely to take place over the next several years are moving the system steadily in that direction.

Melanie L. Lau

Qatar's Well-Managed, Well-Endowed Economy

Qatar's production of crude oil fell 14% in 1981 to an average of 405,000 barrels per day—the lowest level since 1973. The rate of output thus far in 1982 has fallen still further, as world demand for OPEC oil has remained weak. And while fourth-quarter output should be buoyed by seasonal demand and by a slowdown in the rate of global inventory drawdown, average output for the year as a whole is not expected to exceed last year's average and could be smaller.

Qatar's oil prices have also been affected by the soft market conditions. Assuming prices remain at about their current level for the rest of the year, the average price of Qatari oil for 1982 is expected to be around $34.60 per barrel—down some 6.5% from last year's $37.04.

The economy of Qatar will remain heavily dependent on its oil and gas resources for many decades to come. Proven domestic reserves of crude petroleum—which generates the bulk of state revenues—are around 3.58 billion barrels. At the 1981 rate of production, these would last some 24 years. But projections published by OPEC indicate that, owing to both the slow projected growth of world demand for OPEC oil and technical considerations aiming at prolonging the life of existing fields, Qatar's oil output will drop to 300,000 b/d by 1985 and to 200,000 b/d by 1990.

Fortunately, however, Qatar has huge reserves of natural gas—a major portion of which are not associated with its oil reserves. The North Field, located off Qatar's northeast coast, is one of the largest sources of non-associated gas ever discovered. Estimates of its recoverable reserves range from 100 billion to 300 trillion cubic feet. Qatar is counting on this resource to support its long-term development.

The primary immediate effect on Qatar of the drop in oil output during the last several months has been the concomitant decline in associated gas used as fuel or feedstock for some of the country's heavy industries as well as power and desalination plants. This has highlighted the need to exploit the massive North Field gas reserves. Negotiations between the government and potential foreign joint-venture partners have been going on for some time now. At present, official expectations are that a joint-venture partner will be selected by the end of next year to take a 20% stake in the $6 billion project. Once an agreement is finalized, it will be at least six to seven years before the first liquified natural gas shipment is made.

The state budget and economic policy

The management of Qatar's economy continues to be described by observers as cautious and prudent, particularly by regional standards. Following two years of fiscal restraint to alleviate inflationary pressures—which brought inflation down to less than 10% in 1980 and 1981 from over 30% in the mid-1970s—the government's budget became more expansionary. Fiscal 1979/80 and 1980/81 saw increases in expenditure allocations of 24% and 22%, respectively.

The current budget covers the 18 months beginning October 1981 through mid-April 1983. With the exception of the recently announced scaling-back of plans to construct public buildings, there have been few signs of a sharp curtailment of planned development projects, despite speculation to the contrary. However, given that major projects have already come on stream, it is unlikely that Qatar's actual public expenditures during 1981/83 will be much higher—if at all—than during 1980/81. Public spending could, however, begin to increase once plans have been finalized for exploitation of the North Field gas reserves.

Qatar has registered current-account surpluses on its balance of payments since 1974. Soft demand for OPEC oil, however, has trimmed the surplus from a peak of around $3 billion in 1980 and 1981 to around $2 billion estimated for this year. The surplus has been further eroded by loans made to Iraq. The magnitudes of the loans involved are highly uncertain but could easily be running at a rate of $1 billion annually. Demand for OPEC petroleum is not projected to grow noticeably through 1985 or 1986, and real oil prices by then may not be higher than they are today. This, coupled with technical considerations relating to offshore fields in particular, suggests that Qatar's oil output and revenues will not grow substantially over the medium term.

Nevertheless, Qatar's foreign exchange expenditures remain noticeably smaller than current earnings. Thus, surpluses—albeit modest—could easily continue to be registered in the near term. However, a sharper-than-expected drop in oil prices, enlarged financial commitments to Iraq or reparation payments to Iran, or a marked increase in foreign exchange needs connected with the development of the massive North Field gas reserves could cause the surplus to disappear by 1984 or 1985. If so, Qatar's presence in the Eurodollar market may be felt more strongly than it has been in recent years, although the authorities are not likely to permit uncontrolled sudden expansion of public expenditures.

In general, the longer-term outlook for Qatar's economy is good: Its external public debt is negligible, and its accumulated foreign assets totaled $8-10 billion as of the end of 1981. Furthermore, the inevitable exploitation of its huge nonassociated gas reserves—in one form or another—will underpin its long-term development. These reserves are also expected to yield increased export revenues beginning in the late 1980s, and this could easily render Qatar a substantial generator of surplus funds once again. *Sharif Ghalib*

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Changing of the Guard in Germany

The replacement of Chancellor Schmidt's government by a right-of-center coalition led by Helmut Kohl appears to signal a mild shift in Germany's fiscal policy. It also further reduces the chances, at least in the short run, of Germany leading Europe out of its longest and, in many ways, costliest postwar recession.

The fiscal strategy of the new government entails a shift in the composition of public expenditure—away from transfer payments to individuals and toward greater investment incentives for industry. At the same time, the new government, like its predecessor, is hoping to reduce the public-sector deficit. While such a policy should lead to long-term structural improvements, its short-run effect on economic activity depends largely on raising private investment by more than it would reduce private consumption. It is here that a number of additional influences come into play, including: the reaction of Germany's capital markets, actual and expected shifts in Bundesbank policy, and—by no means least important—the expected and actual outcome of a general election, likely to be held next March.

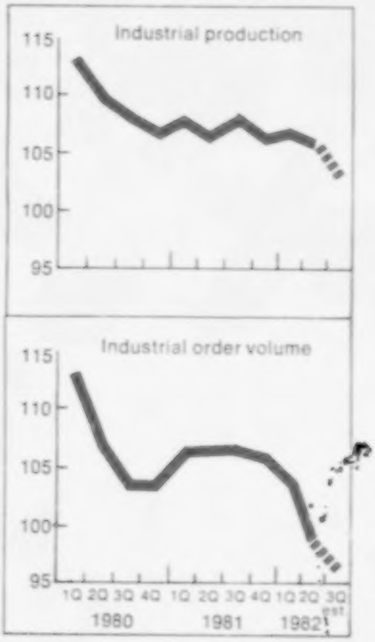
A favorable reaction by the capital markets—meaning a reduction in long-term interest rates from the current yield of over 8.5% on government bonds—depends in part on the market's perception that the authorities will succeed in lowering the public sector's appetite for funds. Uncertainty regarding the outcome of a March election is likely not only to weaken this perception, but also to depress private investment in the short run.

Another consideration is the Bundesbank's reaction to the prospect of a lower public-sector deficit. The central bank has argued that lower public deficits would be helpful to easing key short-term interest rates. However, the primary obstacle to a faster reduction in German money-market interest rates has in recent months been the strength of the U.S. dollar, rather than domestic considerations. And while both the deepening recession and the gains made in bringing down Germany's underlying rate of inflation are likely to reduce the relative weight the Bundesbank assigns to external forces, it does not follow that the central bank has altogether abandoned its commitment to the exchange rate.

In sum, the short-term economic impact of recent political events in Germany is likely to be more dampening than expansionary. And the reaction of the markets—both domestic and international—to the policies of the new government will play a large part in determining the course of the economy over the near term.

Germany's industrial output and orders

index: 1976—100, seasonally adjusted



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Austrian turnaround awaits German economic recovery.

The export-dependent Austrian economy appears to have taken a turn for the worse. Surveys conducted in late summer show that both domestic and export orders are falling. The mid-year production declines in the rest of Europe, particularly in Germany, are now being felt in Austria. The Austrian Institute for Economic Research just recently revised down its 1982 growth forecast to 1% from 2% predicted earlier. On the brighter side, the year-on-year inflation rate has fallen to 5.1% in August from just under 7% at the end of last year, and the current account of the balance of payments has shown a 3.5 billion schilling surplus in the first seven months of 1982, compared with a year-earlier deficit of 9.4 billion. Despite these favorable developments, a sustained upturn in Austria must nevertheless await recovery in Germany, which, at present, is not expected before the second half of next year.

Continued economic retrenchment inevitable for Ireland.

Ireland's senate was recalled from its summer vacation to debate the country's economic situation—an indication of the severity of the problems the government continues to face. Despite its tiny majority, the government has tried to impose some tough policies. Public-sector employees have been held to a stringent pay policy and taxes have been raised substantially in an effort to contain perennial budget deficits. The resultant unpopularity of these programs has led to speculation that a new election will be called before long. There are, however, signs that the government's policies are beginning to work: Ireland's persistently stubborn inflation peaked at a year-on-year rate of 21% in May and then dropped to 17% in August; further falls are expected. The trade deficit has totalled 960 million pounds so far this year, compared with 1.3 billion over the same period last year. The prime rate has been reduced from August's 19% level to 16% and additional reductions are hoped for. Still, the changes recorded to date are no more than a reversal of some worrisome trends. Ireland will have to continue with tough policies for a long time yet before its situation really improves—regardless of which party is in power.

Spanish economy still weak, but balance of payments improved.

With elections scheduled for the end of October, the Spanish economy is showing only minimal signs of emerging from recession. The positive signs are a 17% growth in the value of exports in the first four months of the year, an encouraging tourist season, and industrialists' continuing optimism over order books. But, on the whole, despite some stimulative effects from the burgeoning public deficit, the economy is still weak. Industrial production fell 0.6% (year-on-year) in April, housing starts declined 8.8% over the first five months of 1982, and unemployment has continued to rise. Also, weather conditions have remained unfavorable, which should limit the improvement in agricultural output after last year's drought. With inflation also rising, the only really good news is the improvement in the balance of payments. In the first half of the year, the current-account deficit fell to $3.2 billion, down from $4.1 billion in 1981's first half.

Venezuela moves to bolster international position.

The Venezuelan government has undertaken two measures to strengthen its international financial position. In order to boost the level of official international monetary reserves, the government has pooled the foreign-exchange holdings of state-owned companies with those of the central bank. Also, official gold holdings have been revalued at $300 per ounce. With these actions, international reserves are now estimated at $16 billion, compared with $6.1 billion in August. Another $2.3 billion is held by the government's Venezuela Investment Fund but is not included in central-bank reserves. The government also has proposed to commercial banks that they convert part of Venezuela's $8.8 billion of short-term external debt into longer maturities. This would improve the maturity profile of the country's total external public debt of $18.8 billion. By calling attention to the fact that Venezuela's international monetary holdings approximate the size of its total external public debt, the government hopes to impress the world financial community that the country is in a relatively good position compared with some other Latin American nations.

Peru cuts public spending in accordance with IMF goals.

The Peruvian government has been restraining public expenditures in an effort to meet the targets established with the IMF. Under an IMF-Peruvian government stabilization plan agreed to earlier this year, the public-sector deficit was to be held to 4.2% of GDP. The June 30 goals of the stand-by arrangement were met and a disbursement by the IMF was made in August. In an attempt to meet the next fiscal targets for September 30 the government enacted new cuts in 1982 expenditures and reduced food subsidies. The efforts to slow the public-sector spending have come at a time of declining overall activity. Real GDP expanded at a 4.5% rate in the first quarter of 1982 but slowed to only 0.1% in the second quarter. Manufacturing and construction have been especially hard hit. The balance of payments, however, has improved as a consequence of lower imports and rising oil sales. Net international reserves have also been augmented, which should help Peru to meet another target by year-end.

Malaysian economic slowdown expected to continue.

Sagging demand for its key commodity exports and the resultant squeeze on its financial resources have forced the Malaysian government to trim its projection of 1982 economic growth for the third time this year. The government is now predicting real growth of just 3.5%-4.5% in 1982—down substantially from its initial estimate of 7.2% and from 1981's actual growth of 6.5%. Moreover, the downturn in external demand is spreading to local markets. Public spending is being trimmed in response to lagging government revenues; and consumer spending is waning, as persistently low commodity prices keep agricultural incomes depressed. As a result, production in most sectors of the economy is stagnating or declining and corporate profits are down. The government has indicated that its 1983 budget, to be announced later this month, will be only mildly expansionary. Thus, a revival of economic growth will depend primarily on increased private-sector activity. And unless the world economy rebounds strongly and soon—the signs of which are not apparent yet—the Malaysian economy may not be able to turn in a much better performance next year.

New Bangladesh policy seeks to reestablish private-sector involvement in industry.

Bangladesh's ambitious new industrial policy has made significant advances in the direction of opening up the economy to private enterprise. The new policy, announced in June, expanded the number of industries open to both public and private sectors and dramatically reduced the number of industries reserved as public monopolies. In addition, in order to improve the efficiency and profitability of public-sector corporations, the government has indicated that it will divest part of its holdings and will turn other enterprises over entirely to private management. In particular, the government has agreed in principal to return to private ownership the textile and jute mills nationalized under a previous administration. However, it still remains to be seen whether the government can successfully implement its new industrial policy. Moreover, the recent ban on the domestic production and sale of certain drugs is a sign that the government will continue to intervene in industry in certain circumstances.

Economic rebound forecast for Senegal.

After two successive years of decline, when real GDP fell by an average of more than 6% per year, the Senegalese economy appears to be turning around. Real output is forecast to grow by 6% to 7% in 1982. Favorable weather produced the first good harvest in three years; industrial production is expected to rise by 7%; and investment is likely to show considerable gains this year and next, as work begins on various industrial and infrastructural projects. In the external sector, last year's record current-account and overall balance-of-payments deficits were somewhat eased by the consolidation and rescheduling of $85 million of bilateral debt. The remaining financing gap was closed by EEC funds and IMF credits. This year's outlook is for a significant narrowing of the deficits, owing to a restraint on imports and the rescheduling of some $80 million of commercial bank debt. The 1982 current-account deficit is forecast to decline to $270 million, from $446 million last year, and the overall gap is expected to shrink to $66 million, from $187 million.

The U.S. Economy

New Financial Options: Promise and Problems

After several delays, the Chicago Board of Trade (CBOT) inaugurated trading this month in options on Treasury-bond futures. The new contract is part of the Commodity Futures Trading Commission's (CFTC) three-year pilot program permitting the trading of several commodity option contracts through organized futures exchanges. Because of the flexibility they offer speculators and hedgers, the options provide these traders with an advantage over existing bond futures. Moreover, although they have several obstacles to overcome before attracting enough volume to ensure an adequately liquid market, the options could become an important force in stabilizing prices in the cash market.

The new option contracts, which are "written"—or sold—to other investors, are of two types. The *call option* gives a buyer the right to purchase a Treasury-bond futures contract at a given price—known as the exercise or striking price—within a specified amount of time. The *put option*, on the other hand, gives the buyer the right to sell the underlying futures contract at the striking price on or before the expiration date. The futures contract, by contrast, calls for the delivery of the underlying security—in this case a Treasury bond—at a predetermined date and at a specified price: the futures price.

Both securities offer market participants an opportunity to contract for the future delivery of a bond at a price determined today. In addition, both vehicles give traders a substantial degree of leverage, although in different ways. With futures, investors put up a small percentage of the value of the futures contract as margin, which must be maintained on a daily basis by a procedure known as "marking to the market." That is, if the futures price moves favorably, the investor may remove the surplus, but if it moves adversely, additional margin must be paid. With the option, on the other hand, the leverage arises from the option price, or premium, the investor must pay to buy the contract, which is typically less than 10% of the value of the underlying security. Thus, with the futures contract, the only initial investment is the margin; the futures price, at which the underlying security will ultimately be traded, fluctuates daily in the market. With the option, on the other hand, it is the premium—or initial investment—that is market-determined, while the striking price is arbitrarily fixed. Consequently, with the option the investor cannot lose more than the initial investment, whereas the investor in futures contracts could face potentially unlimited losses in the event of an adverse price move.

The new options allow speculators to profit and hedgers to protect themselves from changes in long-term interest rates. For instance, the buyer of a call option will profit if rates fall and push the price of the underlying futures contract above the striking price by more than the amount of the original pre-

Asia and Oceania

Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF				
			6 months ending	12-month change	in billions of dollars	$ per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of credit, lions of d
Asia	Bangladesh	Scope for private sector investment expanded; phased divestment of public holdings planned.	April	14%	11.6[1]	126	Aug.	169	− 24%	0.8	408
	Burma	Strong growth expected, thanks to isolation from world economy and good rice crop.	Jan.	3%	5.3[1]	146	Aug.	105	− 60%	4.0	50
	China, People's Republic	Strong domestic growth forecast owing to recovery in heavy industry and good harvest prospects.	June	− 10%	260.0	260	May	6,556	− 54%	3.6	492
	Hong Kong	Concerns arising from China lease question affecting property, financial markets.	June	− 7%	24.2	4,695	n. a.	—	—	—	—
	India	Despite recent rains, earlier drought expected to depress foodgrain production and overall growth.	March	− 17%	161.4[1]	236	April	4,765	27%	4.4	1,913
	Indonesia	Slump in foreign earnings continues to depress activity.	Dec.	− 8%	77.5	500	March	5,235	15%	4.5	0
	Japan	Consumer spending may have weakened; investment plans being pared; fiscal stimulus likely.	July	6%	1,130.3	9,690	Aug.	24,415	− 11%	2.2	0
	Korea	First-half growth 4.6%; business stimulation package spurs slow recovery.	July	− 1%	63.4	1,638	Aug.	2,333	− 6%	1.2	1,247
	Malaysia	Government growth estimate for 1982 now trimmed to 3.5%-4.5%.	April	8%	23.6	1,638	June	3,382	− 14%	3.4	269
	Nepal	Fiscal 1982-83 budget calls for large increase in development spending.	June	− 33%	2.4[2]	157	May	216	− 16%	6.6	17
	Pakistan	Poor export performance depressing domestic activity.	June	− 23%	30.7[1]	359	Aug.	1,164	− 47%	2.7	1,178
	Philippines	Coconut levy abolished but copra exports banned.	Dec.	10%	38.6	780	Aug.	1,825	− 20%	2.6	857
	Singapore	Construction, financial services sectors buoyant; manufacturing depressed by weak exports.	June	− 3%	12.5	5,121	May	7,589	− 14%	3.2	0
	Sri Lanka	Election later this month will determine path of economic policies.	March	− 4%	4.4	291	Aug.	302	− 28%	2.3	394
	Taiwan	Economic growth was only 3.5% in first half 1982; weak world demand acts as drag.	April	− 4%	45.5	2,530	April	7,648	− 168%	4.7	0
	Thailand	Domestic demand depressed by low commodity prices; growth may be under 5%.	May	5%	36.1	750	Aug.	1,472	− 6%	2.1	638
Oceania	Australia	Budget finances income-tax cuts, increased family assistance through higher sales taxes.	Aug.	− 3%	159.4	10,724	Aug.	3,581	− 66%	1.5	0
	New Zealand	Budget cuts income taxes as quid pro quo for wage freeze, raises sales taxes.	June	− 3%	24.4[1]	7,858	Aug.	454	− 23%	0.9	12

[1] Fiscal year [2] Previous fiscal year

mium. If rates do not fall, the holder simply does not exercise the option, and the only loss is the original premium. Similarly, to profit from rising rates, the speculator would buy a put option. Moreover, nonfinancial corporations can buy put options to hedge against rising financing costs, while pension funds and other institutions or individuals can earn additional income from option premiums by writing call options against portfolios of bonds they own.

Because of the potentially large number of traders, many observers expect the options market to be quite active, although volume in the first few days has been extremely light. The dearth of initial interest has been attributed to the public's lack of familiarity with this complex instrument, but there are other obstacles as well. First, options on commodity futures contracts were the vehicle of fraudulent activities on the part of several small firms in the 1970s. And although the CFTC has issued stiff regulations to ensure the legitimacy of the new contracts, some investors still have lingering suspicions to overcome. Second, until the market becomes well-established, newspapers do not intend to report price quotations on their financial pages. In the interim, however, the CBOT will list closing prices in serialized advertisements. Finally, although the market would be deepened by the listing of financial-futures options on other exchanges, the main securities exchanges cannot currently do so: They are regulated by the Securities and Exchange Commission, which has no authority to regulate options on futures contracts.

If these problems can be overcome, however, options could serve to stabilize bond prices in the cash market by providing investors greater flexibility than futures contracts. The lack of a "mark-to-market" feature on the option allows an investor to suffer an adverse price movement without being forced out of the market. With futures, such circumstances would call for the posting of additional margin and, when the margin calls cannot be met, for the closing of the positions. Consequently, if bond prices fall dramatically, some long futures positions could be closed, increasing selling pressure in the market and worsening the price decline. Similarly when prices rise sharply, some short positions could be closed, and the resulting buying pressure could further boost the price rise. When interest-rate speculation is accommodated by options, on the other hand, price fluctuations may not be intensified by developments in the ancillary market. When adverse price movements occur, the options are simply not exercised, so that no additional pressure is created to magnify the price movement.

Because of the close connection between the cash market and the futures market, price fluctuations in the two markets tend to be highly correlated. As a result, the influence of volume changes on the futures and options markets tends to be reflected in price movements in the bond market itself. Thus, to the extent that the introduction of the options market will encourage more speculative and hedging activity to be done through options, bond prices may tend to become relatively more stable. *Carl Alan Batlin*

YMENTS		MONEY AND BANKING							COUNTRIES
F l- ars	current influences on payments	12-month changes latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars October 6, 1982	change from year earlier	current monetary conditions	
	SDR 71.2 million drawn under Compensatory Financing Facility.	June	6%	May	+ 1%	.0443	−31%	Credit continues restrictive.	**Bangladesh**
	Reserves have declined sharply since mid-1981.	Jan.	+ 2%	Apr '81	+13%	.1267	−10%	Kyat remains pegged to SDR.	**Burma**
	Jan.-June trade surplus was $2.4 billion; import restrictions continue.	Dec.	+ 3%	March	+16%	.5191	− 8%	Increased personal savings boosts housing construction.	**China, People's Republic**
	Exports remain disappointing; HK dollar weak.	Aug.	+11%	July	+10%	.1577	− 5%	Bank run an isolated incident.	**Hong Kong**
	Exports hurt by weak world demand, textile strike; foodgrain imports necessary.	June	+ 7%	March	+ 7%	.1032	− 7%	Deposit growth slows.	**India**
	Oil prices unchanged; first counterpurchase agreement signed.	June	+ 9%	April	+32%	.00149	− 7%	Government tightens money grip to moderate inflation.	**Indonesia**
	Exports depressed by world recession, trade restraints; weak yen no help.	Aug.	+ 3%	July	+ 5%	.00363	−17%	Weak yen continues to prevent further monetary easing.	**Japan**
	Despite sluggish exports, trade deficit narrows owing to weak imports.	July	+ 5%	June	+14%	.001347	− 8%	Easier monetary policy adopted.	**Korea**
	Slack demand, depressed commodity prices pull down exports.	July	+ 5%	May	+10%	.4212	− 2%	Net foreign borrowing for 1982 forecast at $1.7 billion.	**Malaysia**
	Customs duties on luxury imports raised; incentives given to exports.	June	+ 9%	Jan.	+14%	.0758	− 5%	Regulations on credit and loans simplified.	**Nepal**
	Fiscal 1981-82 current-account deficit now estimated at $1.53 billion.	June	+ 9%	July	+14%	.0805	−21%	Depreciation of rupee slowed.	**Pakistan**
	Recent interest-rate drop lowers debt servicing costs.	June	+13%	July	+ 1%	.1151	−11%	Gov't. announces plans to lift remaining interest ceilings.	**Philippines**
	Exporters complaining about strength of Singapore dollar.	July	+ 2%	May	+ 8%	.4575	− 5%	Nominal rates lower but real rates remain high.	**Singapore**
	Depressed prices for tea, rubber, coconut products hurt exports.	June	+11%	May	+21%	.0478	− 9%	Rupee shows little movement.	**Sri Lanka**
	Import restrictions on Japanese goods lifted.	April	+ 4%	April	+ 9%	.0251	−10%	Deposit ceiling for foreign bank branches raised.	**Taiwan**
	Commodity exports show strong volume increases, thanks to '81's good harvest.	July	+ 5%	Dec.	+ 2%	.0435	− 3%	Domestic interest rates ease.	**Thailand**
	Overall deficit recorded in July as capital inflow slows.	June	+11%	July	+ 1%	.9492	−18%	Government reaffirms commitment to 9%-11% target.	**Australia**
	Current-account deficit widens because of imports for energy projects.	June	+17%	March	+15%	.7184	−14%	Routine monthly adjustment of NZ$ against US$ suspended.	**New Zealand**

World Interest Rates

market rates of Oc: 6, 1982; bond yields as of Oct. 1, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	10.00	12.98	10.125 intervention rate	12.50	9.50	7.00	18.00 penalty rate 21.00	7.00	5.00	5.50
Day-to-Day Money	9.75 October 7	15.00	10.50	11.80	14.00	7.80	18.50	8.875	1.50 1-month Euro-Swiss fr. rate	7.0625
Treasury Bills 91-day, Middle Rates	8.05	12.75	9.9375	12.75	n. a.	n. a.	16.151 85 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	10.75 finance paper discount basis	13.15 finance paper 15% tax w/h	9.706	12.20 Certified	14.00 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	10.30	12.85 15% tax w/h	9.875	12.40 Certified	not traded	8.50	19.70	no market	4.1875	no market
Government Bonds Long-term, new and old issues, average yield	11.58	13.38	10.85	9.849 20% tax w/h	15.60	8.41	19.16	9.99	4.44	8.182
Industrial Bonds prime, long-term, new and old issues, average yield	13.30 Aa Industrials	14.75	12.53	15.427	16.37	8.46	19.70	10.82	5.94	6.70
Bank Short-Term Rate to Best Borrowers (prime rate)	13.50	15.00	10.00 October 7	16.25	16.05	11.50	20.75 ⅛ qtrly fee on outstdng.	9.50	9.00	6.00
Bank Time Deposits 3-month	10.50 Cert. of Dep.	13.25	10.375	12.70	14.00	8.00	11.50	7.875 large deposits	3.25 residents only	3.75
Eurocurrencies 3-month, asked	11.75	13.375	10.50	no market	17.125	7.625	no market	7.75	4.1875	7.3125
Exchange Rates—in U.S.$ rates floating against the $	—	.8068	1.6875	.0202	.1383	.3910	.000695	.3581	.4540	.003636
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.75 *D*	1.25 *D*	1.50 *D*	5.50 *D*	4.25 *P*	7.75 *D*	4.00 *P*	7.50 *P*	4.50 *P*

Eurodollar Deposits

(London, interbank, bid)
October 7

7-day	10.5625
1-month	11.00
3-month	11.375
6-month	11.6875

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−0.501
U.S.-Canada Treasury Bills	−2.388
U.S.-Canada Finance Co. Paper	−0.470
Eurodollars-U.K. Local Auth. Deposits	+2.688

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	12.75
Over 7 yrs.	13.125
DM Bonds	
7 yrs. and under	8.375
Over 7 yrs.	8.625

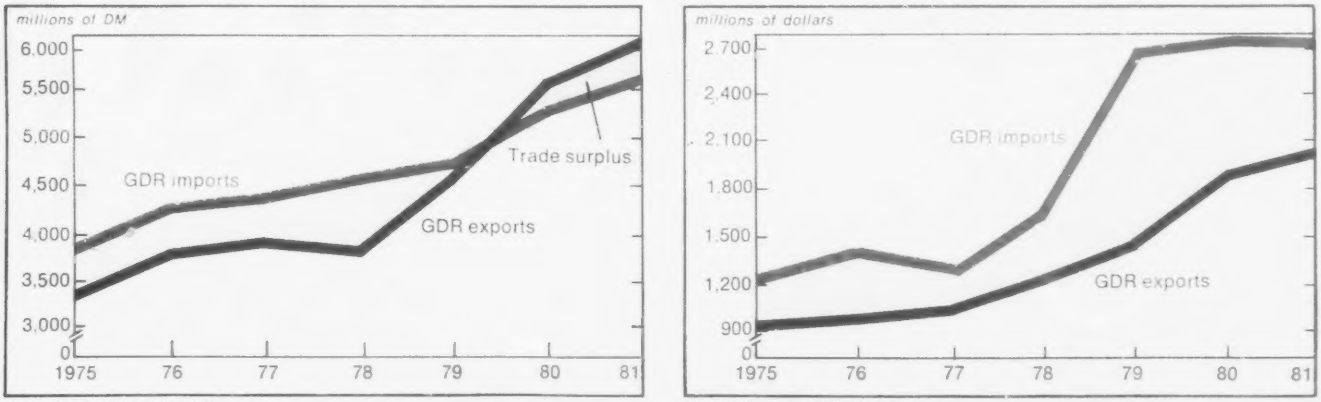
Gold Price

London afternoon fixing

404.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Foreign Trade of the German Democratic Republic



With West Germany

Data: Federal Republic of Germany

With other OECD nations

Data: International Monetary Fund

GDR: Learning to Cope With Less

Since 1980, all of Eastern Europe has experienced a difficult period of austerity and adjustment, an ordeal caused by errors in domestic policies as well as pressures from the Soviet Union and Western credit markets. In the case of the German Democratic Republic (GDR), a basic strategy for structural adjustment in the 1980s had been designed as early as 1979. All combines and ministries had then been directed to reconsider their investment plans and project designs to take account of rising costs for energy and raw materials and the limitations on future Soviet deliveries of such commodities.

External developments during 1981 led GDR planners to accelerate the adjustment process. The most significant of these was the situation in Poland with its consequences for Soviet financial strength and the availability of Western credits. The direct impact of Poland's economic collapse on the GDR was serious but not catastrophic. Poland's exports to the GDR—metallurgical coal, electrical machinery and consumer products, primarily—had been declining in volume since 1977 and substitutes could be found in Western or Eastern markets during 1981, albeit at higher cost.

Even without the Polish crisis, however, adverse conditions in the world economy during 1981 would have pushed the GDR toward import restrictions. The deepening recession in the West—particularly severe in the European Community—reduced both the volume and prices of GDR exports of manufactured products. High nominal interest rates, positive real interest rates, and a strong dollar increased the burden of external debt. In this situation, problems with the rescheduling of Polish commercial debts reduced the volume of Western credits available, raised the price on new credits to borrowing Council for Mutual Economic Assistance (CMEA) countries, and shortened the maturity structure of GDR debt.

Another influence was the deteriorating economic position of the Soviet Union. Beset with a third successive harvest failure, declining production levels of coal and steel, adverse shifts in Western markets, and the pressure to cover Poland's trade and financial needs, Soviet leaders had lost patience with the more successful economies in Eastern Europe—Hungary and the GDR. Consequently, when the USSR-GDR trade agreement was finally ratified late in 1981, the GDR faced a reduction in the volume of Soviet deliveries of fuels under favorable CMEA pricing formulas. If the GDR wished to purchase more, the increment would have to be paid for at the world price—in dollars, food, consumer goods, or quality machinery.

Soviet pressures were responsible for most of the changes evident in the five-year plan (1981-85), published in December 1981. In particular, the plan called for a reduction in total capital investment over the five-year period and the establishment of a target for exports to socialist countries—an increase of 50% by 1985 or 8.4% per year. The deterioration in the prospects for East-West trade and Western credits may have reinforced those changes, but the principal determinant was the USSR decision to accelerate the GDR's trade adjustment in order to reduce the Soviet burden of trade subsidies. Cuts in capital investment were primarily in the machinery component rather than in construction. Machinery released from domestic investment could then be exported abroad. The shift in the foreign-trade target toward exports to socialist countries clearly indicates that deliveries of machinery to the Soviet Union are to receive top priority during the 1980s.

One of the most important targets in the five-year plan is the reduction of specific consumption in energy, raw materials, and supplies at an annual rate of 6.1%. This is to be accomplished in part by rationalization of existing technical processes, but most of the gains are to be achieved through redesign of products and shifts in the composition of output.

Status of the adjustments in 1982

With only limited credit available in the West, GDR authorities slowed economic growth during 1982 in order to reduce the demand for imports and free more resources for exports. National income produced (net material product) grew 3% in the first half of 1982 relative to the first half of 1981. In comparison, national income produced increased 5% in 1981. Gross industrial output under industrial ministries grew around 4% in the first half of 1982, compared with the original target of 5.1%.

Investment expenditure during the first half of 1982 (excluding capital repair) amounted to 22 billion marks. This figure represented a decline of 6%-7% in nominal terms and an even greater decline in real terms. Furthermore, the output of the construction industry continued to grow, so investment in machinery and equipment probably fell by more than 10%. This year's reduction in machinery installation reflects the substantial cutback in imports of Western machinery and equipment as well as efforts to export a larger volume of GDR machinery to the Soviet Union.

Foreign trade in 1981 and 1982

Recently released statistics reveal the GDR's trade results for 1981. For the first time since 1974, the Central Statistical Office published the value of exports to and imports from socialist and non-socialist countries

GDR: Learning to Cope With Less *(continued from page 7)*

separately, instead of merely reporting the trade turnover—that is, the sum of exports and imports. However, the data for bilateral trade as well as for aggregate trade with CMEA, the developed West, and developing countries are still reported only on a turnover basis. For 1981, the new data show that:

- Exports to non-socialist countries increased 27% (measured in valuta marks, a monetary unit used for accounting purposes only) in spite of the world recession.
- Imports from non-socialist countries declined 4% as hard-currency imports were restricted by financing constraints in Western capital markets.
- This adjustment eliminated the large deficits of recent years and produced the GDR's first trade surplus with non-socialist countries since 1968.
- At the same time, GDR exports to socialist countries rose less rapidly than did imports so the ruble deficit more than tripled to around 275 million rubles in 1981.

There still remain difficulties in the interpretation of GDR trade statistics—questions which pertain to exchange-rate methodology and country composition. There has always been a significant discrepancy between GDR statistics on trade with the West and mirror trade statistics of OECD countries and West Germany. But this discrepancy appears to be much larger in 1981 than in recent years. According to Western statistics, GDR exports to industrial countries actually declined more than 6% in 1981 when measured in current dollars, rather than the 27% increase implied by GDR data.

Given the inner-German clearing facility, trade transactions in deutsche marks are not fully convertible for the GDR. Moreover, around 60% of GDR exports to the West in 1980 were DM transactions and recorded as such before being converted to valuta marks. Conversion rates for dollars and DM are specified before the calendar year for guiding foreign trade organizations and GDR enterprises. Western analysts know neither how such conversion rates are determined nor how accurately they are revised at the end of the year for statistical purposes. The pattern of discrepancies between GDR and Western data suggest that dollar and DM trade transactions are not aggregated *ex post* with the average market cross-rate.

Despite the difficulties in reconciling available GDR trade data, domestic adjustments in energy and material consumption and in agriculture clearly permitted a large foreign-trade adjustment during 1981. Some portion of the export growth in the category of fuels, minerals and metals must have taken place through a reduction of inventories. Consequently, such a sizable swing is unlikely to take place again during 1982 when restocking becomes necessary.

Nevertheless, the GDR's foreign-trade adjustment continued through the first half of the year. Over that period total exports rose 10% relative to the first six months of 1981. The trade surplus with non-socialist countries grew to over 1 billion DM—an unprecedented level. The announcement of this figure reflects concern about the Western perception of GDR financial problems.

Preliminary data for inner-German trade show that the GDR's trade surplus is continuing to grow. The cumulative deficit under the "swing" facility fell to 3.4 billion DM at mid-year. The composition of GDR imports reflects the ongoing domestic adjustment and shifts in relations with other trading partners: GDR imports of machinery fell sharply given cutbacks in domestic investment, and the renewed shipments of Polish coal allowed the GDR to cut its coal purchases in West Germany. Offsetting these two developments were increased GDR imports of agricultural goods (mainly grain and fodder) no longer as available from the United States and larger imports of non-ferrous metals. The latter stems both from the need to restock depleted inventories and from opportunities to buy at depressed world metals prices.

Financing questions

The sharp adjustment in the GDR's trade with non-socialist countries has been reflected in the positions of Western commercial banks as reported to the Bank for International Settlements. Altogether, the available trade data and capital flows suggest that the GDR reduced its current-account deficit to $500 million or less in 1981—a dramatic improvement over deficits in excess of $1.5 billion in 1979 and 1980.

In the first quarter of 1982 there was an abrupt contraction of GDR positions with Western banks. The $644 million decline in reserves was more than offset by a $902 million fall in GDR liabilities. Quite clearly, foreign-exchange reserves were being used to repay medium-term debts as well as to cover short-term loans not being rolled-over by commercial banks. Despite evident resistance to medium-term borrowing, the GDR chose not to utilize available credit from the "swing" facility with West Germany. This decision was probably due to political considerations given the negotiations over inner-German relations taking place in the spring. On June 18, a new agreement was announced that will progressively reduce the annual credit availability to 600 million DM by 1985. With the agreement now complete, the GDR may well shift more of its purchasing back to the Federal Republic in order to utilize the "swing." In any case, the GDR is projected to achieve a surplus on current account in 1982 as well as an absolute reduction in its hard-currency debt to the West.

Donald W. Green

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A Watershed For Fed Policy?

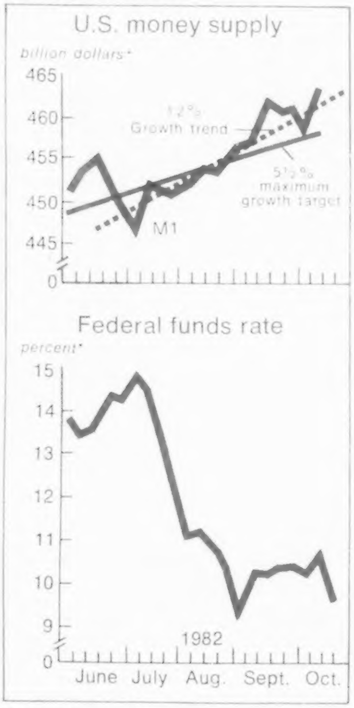
Recent weeks have witnessed an unusual combination of economic events in the United States: a surge in the money supply well above its targeted growth path, a spectacular decline in interest rates, and a rocketing of the Dow Jones Industrial Average through the 1,000 mark. With the economy still mired in a major recession—the unemployment rate is now 10.1% and rising—the rallies in the stock and bond markets may have little to do with any optimism about the prospects for economic growth. Instead, the critical catalyst may have been the turnaround in Federal Reserve policy.

In defending its new posture on policy and the recent monetary bulge, the Fed has declared that inflation has been defeated, implying that the economy can take a strong dose of money without inflation being rekindled. Furthermore, Fed officials have argued that the closely watched M1 concept of the money supply is now so ambiguous that it has become worthless as an indicator of policy. These certainly are plausible rationales. The economy is in recession and inflation has receded dramatically. Moreover, innovations in the financial markets have changed the interpretations that should apply to the various monetary aggregates (although in the past the Fed has managed to cope with this problem by contriving such indices as "M1 Plus" and "Shift-adjusted M1").

A more appropriate justification for a once-and-for-all upward adjustment of the money stock, however, depends on a careful understanding of money demand. Money velocity—the speed at which money is passed from hand to hand—accelerates as inflation increases, since rising inflation penalizes those who hold onto their money. But, as inflation becomes less of a problem, the penalty is reduced. Thus, the velocity of money may temporarily decline or move to a slower growth path. This means that a given level of economic activity needs a one-shot infusion of money to help ease the transition from high and rising to lower and falling inflation. Economists refer to this as a "stock" adjustment, which may differ from the "flow" demand for money that relates to long-run nominal economic growth.

If, on the other hand, the Fed continues to prime the pump beyond year-end, its actions may be interpreted differently. Such a policy would risk re-igniting inflation, and interest rates would be off to the races again. But fortunately, while inflation takes time to stop, it also takes time to start. The message here is that one quarter's money explosion does not establish a trend. It will not be known until next year whether the Fed has been playing politics or acting responsibly.

U.S. money growth and interest rates



*seasonally adjusted

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Current-account surplus forecast for Canada owing to continued recession.

The Canadian current account in 1982 promises to show a substantial improvement over last year's C$5.35-billion deficit. In the first and second quarters of this year, Canada enjoyed seasonally adjusted current-account surpluses of C$220 million and C$588 million, respectively. The major reason for this good news, however, has been the severity of the Canadian recession: Unemployment stood at 12.2% in both August and September, and the latest available data show that industrial output and new orders to manufacturers fell in July while the inventory-to-shipment ratio rose. As yet there are no signs the economy has begun its recovery, although the recent statistics indicate it has at least bottomed out. Nevertheless, Canada's recovery will probably lag that of the United States. Consequently, 1982 may bring the country its first whole-year current-account surplus since 1973.

Downturn forecast for Switzerland as listlessness pervades economy.

All signs point to a continued slowdown for the Swiss economy. The latest data show that real GDP in the second quarter was 0.4% below the level registered for the same period in 1981. And a number of recent indicators suggest a further weakening of economic activity took place over the summer months: Industrial production fell, unemployment continued to climb while job vacancies collapsed, and import growth remained slack. Consumer demand is still weak and investment outlays have been cut back severely. And now construction—which had been the mainstay of growth in recent years—is also going into decline. There is little prospect the economy will pick up before mid-1983. Business surveys show that orders are falling and stock levels remain well above desired levels. Overall, 1982 real GDP seems likely to decline by around 1.5% following growth of 1.9% in 1981.

Despite economic slump, Belgian government strives to contain budget deficit.

The Belgian economy remains in recession. Official expectations are that real GNP this year will grow 0.5% at best, while inflation is forecast to accelerate to around 9%-10%. At the same time, however, the current-account deficit is expected to fall by some 20% from last year's $5.2 billion shortfall. Despite the continued sluggishness of the economy, the government has proposed a tough 1983 budget: Current expenditures are projected to rise by 7.5%—against an officially projected 1983 inflation rate of 7.6%—and capital spending will be down by almost 4%. The government's net financing requirement is forecast to decline from 12.7% of GNP in 1982 to 10.5% next year, and the gross borrowing requirement (which includes borrowing to repay existing debt) will fall from 16.7% of GNP in 1982 to 15.8% in 1983. As a result, the government projects real GNP will grow by some 1.3% in 1983. But with the German outlook continuing to worsen, even this forecast could prove to be overly optimistic for Belgium's export-dependent economy.

Competitive devaluations among the Nordic countries.

The relative stability that usually characterizes the currencies of Scandinavia and Finland has turned to turmoil over the past few months. In early August, the Norwegian central bank's updating of the weights used to calculate the trade-weighted value of the kroner led to an effective devaluation of that currency by some 3%. On September 6, the kroner was officially devalued by an additional 3%. Exactly one month later, Finland devalued the markka by 4.3%. Then on October 8, after hurried consultations held at Stockholm's International Airport with officials from the other Scandinavian countries, Sweden devalued its kronar by a full 16%. This action elicited strong criticism from the Finnish government and a further 6% devaluation of the markka on October 9. The Scandinavian nations and Finland have had above-average inflation rates and some compensating currency devaluations had been expected. Nonetheless, the flurry of downward movements has posed problems. First, it has raised suspicions among the countries—which usually have relatively strong common interests—that these exchange-rate adjustments (plus others that may be still to come) represent unjustified attempts to gain an unfair trading advantage. Second, the changes have left the Danish kroner in an extremely exposed position, already igniting adverse speculation. As a member of the European Monetary System, however, Denmark cannot change its exchange rate without prior discussion with its EMS partners. Still, because trade with Finland and with the other Scandinavian countries represents such a significant portion of Denmark's total international trade, the other members of the EMS are expected to be tolerant of the Danish quandary. Consequently, over the near term, further speculation on exchange-rate adjustments seems inevitable. The longer-run outlook will depend on whether the adjustments already made will encourage additional steps to help contain inflation and strengthen balance-of-payments positions. Without these improvements, the devaluations will be no more than temporary—if nonetheless expedient—palliatives, and further devaluations can be expected to occur.

Ecuador requests refinancing of public-sector bank debt.

Ecuador has requested the refinancing of $1.22 billion in foreign-bank debt falling due between November 1982 and December 1983. Its total external public debt now stands at $4.68 billion, of which 64% is owed to private banks. The government took the initiative for a number of reasons: Oil export income, which brings in over 60% of total export receipts, has declined 15% this year because of softer prices. Moreover, short-term loans—accounting for some 70% of the $1.22 billion—have created a sharp bulge in the debt profile. And finally, the volume of medium- and long-term external credits available to Latin American countries has been sharply reduced this year because of regional and international debt concerns. Ecuador already has backed its request by eliminating gasoline and wheat subsidies. Efforts are also underway to reduce the public-sector deficit and improve the trade balance. But as the adjustment process unfolds, economic growth is bound to slow.

Japan's stimulatory package unlikely to trigger recovery.

Shortly before the sudden resignation of Japanese Prime Minister Zenko Suzuki, the government adopted a modest 2.07 trillion yen stimulatory package for the second half of the fiscal year ending March 31. The economy had shown surprisingly good growth during the first two quarters of 1982—annual rates of 4% and 5.2%, respectively—thanks to unexpectedly strong consumer spending and the acceleration of public-works investment. But with exports depressed and showing no sign of recovery, consumer spending turning sluggish because of unseasonably cool weather, and large firms beginning to scale back their investment plans because of the poor business outlook, the government felt compelled to act to stem any further economic deterioration. The room for maneuver, however, was severely constrained. A loosening of monetary policy threatened to further weaken the yen, while the adoption of a more stimulative fiscal policy threatened to swell the budget deficit. Suzuki's rather modest measures reflect this dilemma, and the next government will necessarily find itself in the same boat. A little pump-priming may help support the economy at its current level, but it is not likely to lift Japan out of its economic slump.

OPEC's current account headed for 1982 deficit.

The OPEC nations' combined current-account surplus in 1981 narrowed to about $57 billion (after official transfers) from $106 billion in 1980. This sharp contraction occurred despite a 10.5% hike in the average effective OPEC oil price to $34.25 per barrel, and a 19.2% rise in non-oil exports of goods and services to $62 billion. Soft world demand for oil—reflecting economic recession in the West as well as continued energy conservation—caused a drop of 16.4% in OPEC oil output last year to an average of 22.5 mbd, yielding gross oil income of $251 billion. And imports of goods and services as well as transfer payments continued to expand, albeit at a slower pace than previous years, rising 14% to $256 billion. For 1982, the current-account balance is projected to deteriorate much more sharply. OPEC oil production will drop again, averaging about 19 mbd, despite the expected pickup in world demand during the fourth quarter. Moreover, the effective oil price is likely to average $33 per barrel, down almost 4% from 1981, yielding gross oil income of $200 billion. And payments for imports, as well as transfers, are expected to rise by 7% to $274 billion. Even allowing for non-oil exports of $66 billion, OPEC's combined current account looks set to swing into a deficit of about $8 billion.

An Ambiguous Economic Report Card

The third-quarter GNP statistics released last week offered mixed [illegible] about the health of the U.S. economy. The optimists, noting that the [illegible] annual rate of real growth was the second consecutive quarterly increase, asserted that it confirmed their belief that [illegible] recovery is indeed under way. At the same time, however, the pessimists pointed out that, as in the second quarter, the [illegible] in inventories accounted for [illegible] the rise. And since final sales actually fell, a true recovery is still not in sight. [illegible] the truth, the economy's [illegible] performance will probably prove to be somewhere in between.

The consumer sector was one of the [illegible] bright spots of the economy. Since consumer expenditures account for about 65% of GNP, it is extremely difficult for a recovery to begin without a strong pull from consumers. For the last three quarters, real consumer spending rose at an annual rate of 2%, which more than offset declines in other sectors. However, real disposable personal income has only been [illegible] but as spending [illegible] with the boost from July's tax cut. As a result, personal saving as a share of income is now lower than it was before the recession started. And with [illegible] unemployment, some consumer [illegible] to rebuild savings can be expected.

The government sector was also relatively buoyant in the third quarter. Defense spending continued its solid advance, but almost half the rise in federal spending was attributable to a temporary increase in agricultural spending that will be reversed in the future. And this turnaround, when coupled with the continued downward drift of state and local government spending, should more than offset the increase in military spending.

From the optimists' view the outlook for investment spending is quite gloomy. Capacity utilization moved below 70% in the spring, foreshadowing sharp reductions in business spending at an annual rate. And even some optimists expect only a moderate increase in residential spending, about the best that can be hoped for from housing in view of the sharp [illegible].

[illegible] trade is the other major sector of the economy that has been performing poorly. The volume of U.S. exports has continued to fall and is now down 7% from a year ago, while import demand has rebounded from its low level last winter. If other countries manage to stimulate their depressed economies, a [illegible] in exports could occur. But if domestic policymakers follow suit, the expansive effects of higher exports could be offset by a boost in imports.

Over the longer run, the recent declines in interest rates should begin to revive consumer confidence and lead to an upturn in demand. In fact, the [illegible] increase in housing starts in September may be the first sign that the United States is on what will be a long road to a sustainable recovery. —[illegible]

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF				
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of credit, lions of
Argentina	Some economic revival, thanks to low real interest rate policy, but inflation is accelerating	June	8%	178.0	$4,547	June	2,908	-23%	6.6	[illegible]
Barbados	Government adopts IMF plan to reduce fiscal deficit by cutting spending and raising taxes	May	-17%	0.9	3,575	Aug.	73	21%	1.5	[illegible]
Bolivia	Civilian government replaces military, facing difficult period of austerity and large debts	April	10%	6.0	1,050	June	99	45%	2.0	[illegible]
Brazil	Stiffer bank reserve requirements imposed to restrain credit and imports; economy at low level	July	13%	284.8	2,337	July	6,068	-15%	3.5	[illegible]
Chile	IMF credits of $900 million under consideration as international reserves decline	June	7%	29.3	3,126	Aug.	2,914	-32%	6.9	[illegible]
Colombia	New government puts limit on public spending growth, stresses agriculture and construction	May	-12%	37.1	1,399	Aug.	4,304	10%	9.0	[illegible]
Costa Rica	Government considers tax measures as part of IMF stabilization plan to reduce public-sector deficit	Jan.	3%	9.0	2,200	Aug.	283	75%	2.8	[illegible]
Dominican Rep.	New president proposes taxes, spending cuts, and wage-price freeze as part of austerity plan	July '81	0%	7.2	1,335	Aug.	55	71%	0.6	[illegible]
Ecuador	Government requests commercial banks to extend, refinance Nov. 1982-Dec. 1983 public-sector debt	April	10%	11.8	1,604	Aug.	365	-47%	2.1	[illegible]
Guyana	Economy in difficult straits as foreign-exchange scarcity limits key imports; inflation, unemployment up	March	-28%	0.5	605	Aug.	7	-14%	0.1	[illegible]
Jamaica	IMF providing a record $550 million from various credit facilities to support economic recovery	June	-30%	2.9	1,363	Aug.	115	11%	1.3	[illegible]
Mexico	Large debts, foreign-exchange needs, low demand and inflation dim business outlook	June	21%	238.2	3,303	Feb.	2,281	-28%	1.5	[illegible]
Panama	Economy slows in response to cuts in public spending; new cross-isthmus pipeline in operation	June	17%	3.8	2,017	July	124	-23%	1.0	[illegible]
Paraguay	Construction slowdown expected to push real GDP growth in 1982 down to 4% from 8% in 1981	June	40%	5.5	1,664	Aug.	708	-7%	24.1	[illegible]
Peru	Government reduces food subsidies and cuts spending to help bring down inflation	June	-17%	25.0	1,360	June	1,444	-19%	5.4	[illegible]
Puerto Rico	Recession still grips economy but July inflation down to 3.2% annual rate; unemployment is high	March	16%	11.7	3,656	March	11,295	16%	14.0	—
Uruguay	Loss of international reserves causes contraction of domestic monetary base; IMF talks held	Dec.	7%	10.9	3,711	July '81	403	5%	3.7	[illegible]
Venezuela	Finance minister asks foreign banks to refinance short-term public external debt	June	-19%	68.4	4,454	Aug.	5,648	-30%	5.8	[illegible]

The Markets Interpret Fed Behavior

[illegible]

again. On the other hand, if the apparent policy change is viewed as temporary, bond prices could [illegible] reverse themselves in the immediate future. Thus, like the gold and foreign exchange markets, the bond market may serve as a good interpreter of future Fed activities.

The behavior of corporate issuers may reflect their belief that the rally is temporary. As of mid-October, corporations had issued over $17 billion of new bonds since the beginning of August at rates still in excess of 11 percent for AAA rated firms. Currently, much of the proceeds have been used to refund short-term debt in order to improve capital structures and restore much needed liquidity. However, if corporations believed that the risk of a renewed surge in inflation and interest rates was not significant, they would be postponing the funding process and rolling over their short-term debt to take advantage of further rate declines.

A related consideration is the credit nature of the rally. Although highly rated firms have been able to float new issues, bonds rated BAA and below still carry a substantial risk premium. In fact, this flight to quality is an integral part of the rally since many observers feel that the basic source of the rate decline is the weakness of the economy. As it improves, yield spreads should narrow, allowing some firms to fund [illegible] debt, but the Fed would be prompted to refocus on controlling monetary growth, a move that could trigger a renewed rebound in rates. [illegible] of the rally

current influences on payments	MONEY AND BANKING							COUNTRIES
	latest data	12-month changes consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars October 20, 1982	change from year earlier	current monetary conditions	
[illegible]	June	[illegible]	June	140%	.000037	70%	Domestic interest rates subsidized.	Argentina
[illegible]	[illegible]	[illegible]	[illegible]	9%	.4975	— 4	Public credit restricted.	Barbados
[illegible]	May	[illegible]	May	[illegible]	.0027	47%	External debt in arrears.	Bolivia
[illegible]	[illegible]	[illegible]	April	74%	.0056	59%	Interest costs rising.	Brazil
[illegible]	[illegible]	8	March	2	.0152	[illegible]	Private external debt flows decline.	Chile
[illegible]	June	[illegible]	Dec.	1	.0150	25%	Monetary authorities increasing bank supervision.	Colombia
Free exchange rate declines.	June	[illegible]	Dec. '81	65%	.0245	59%	Foreign debt interest is in arrears.	Costa Rica
Import ban placed on 100 items.	[illegible]	7	June	9	Par	—	Ceilings set on interest rates.	Dominican Rep.
Oil export price up to $32 per barrel.	[illegible]	[illegible]	March	17%	.0202	12%	Monetary policy is restrained.	Ecuador
Outlook poor for export growth.	Dec.	[illegible]	July	21%	.3401	2%	External debt being rescheduled.	Guyana
Tourism showing some improvement.	[illegible]	[illegible]	June	50%	.5600	0	Public sector credit curtailed.	Jamaica
Government allocates foreign exchange.	Aug.	[illegible]	June	30%	.0100	75%	Credit now available.	Mexico
Canal receipts boost services account.	[illegible]	5	May	8	Par	—	Credit is available.	Panama
Minimum 120-day credit set for imports.	Feb.	[illegible]	Feb.	4%	.0079	1%	Rediscount facilities reduced.	Paraguay
[illegible]	[illegible]	[illegible]	April	46	.0013	42%	Central bank curtailing credit.	Peru
July tourism down 11% from 1981.	July	[illegible]	March	7	Par	—	Savings deposits decline.	Puerto Rico
[illegible]	Feb.	[illegible]	[illegible]	0	.0753	18%	Rise in domestic interest rates.	Uruguay
Central bank boosts level of international reserves.	Aug.	[illegible]	March	5%	.2320	0	Domestic interest rates competitive with world rates.	Venezuela

World Interest Rates

market rates of Oct. 20, 1982; bond yields as of Oct. 15, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	9.50	11.62	9.625 intervention rate	12.00 October 21	9.50	6.00 effective October 22	18.00 penalty rate 21.00	6.50	5.00	5.50
Day-to-Day Money	9.375 October 21	14.75	9.78	10.80	14.00	7.55	18.50	7.125	1.625 1-month Euro-Swiss fr. rate	6.8125
Treasury Bills 91-day, Middle Rates	7.55	11.25	8.9375	12.75	n. a.	n. a.	16.15 71 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	8.78 finance paper discount basis	11.60 finance paper 15% tax w/h	8.78	12.20 Certified	13.75 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.80	11.50 15% tax w/h	9.00	12.40 Certified	not traded	8.05	19.60	no market	3.375	no market
Government Bonds Long-term, new and old issues, average yield	10.72	12.78	10.18	9.548 20% tax w/h	15.175	8.19	19.32	9.72	4.33	8.18
Industrial Bonds prime, long-term, new and old issues, average yield	12.00 Aa Industrials	14.75	11.79	15.146	16.16	8.24	20.90	10.35	6.09	6.66
Bank Short-Term Rate to Best Borrowers (prime rate)	12.00	13.75	9.375	16.25	16.05	11.50	20.75 ⅛ qtrly fee on outstdng.	9.00	9.00	6.00
Bank Time Deposits 3-month	8.78 Cert. of Dep.	11.50	9.375	12.70	13.75	7.50	11.50	7.125 large deposits	3.00 residents only	3.75
Eurocurrencies 3-month, asked	9.875	11.875	9.50	no market	21.50	7.00	no market	7.00	3.50	6.9375
Exchange Rates—in U.S.$ rates floating against the $	—	.8150	1.6950	.0204	.1401	.3953	.000693	.3623	.4603	.00368
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.00 *D*	1.00 *D*	3.25 *D*	8.25 *D*	3.00 *P*	10.50 *D*	3.00 *P*	6.50 *P*	3.00 *P*

Eurodollar Deposits

(London, interbank, bid)
October 21

7-day	9.6875
1-month	9.6875
3-month	9.875
6-month	10.125

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−6.402
U.S.-Canada Treasury Bills	−1.243
U.S.-Canada Finance Co. Paper	−0.661
Eurodollars-U.K. Local Auth. Deposits	+1.625

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.78
Over 7 yrs.	12.25
DM Bonds	
7 yrs. and under	8.50
Over 7 yrs.	8.50

Gold Price

London
afternoon fixing

422.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Aug.) 5.9	(Sept.) 10.4	(Sept.) 7.3	(Sept.) 9.9	(Sept.) 4.9	(Sept.) 17.2	(Sept.) 5.5	(Aug.) 3.1
Industrial production*	(Sept.) −9.7	(July) −14.0	(Aug.) 0.6	(June) −0.8	(Aug.) −3.7	(Aug.) 0	(March) 0	(Aug.) 1.2
Trade balance† *(billions of local currency units)*	(Aug.) −$7.08	(Aug.) C$1.35	(Aug.) −£0.037	(Sept.) −FF12.2	(Aug.) DM2.71	(Aug.) −Lit 1,000	(Sept.) −SF0.88	(Aug.) ¥253.6
Money supply (M1)*	(Sept.) 6.8	(July) −2.5	(July) 11.2	(July) 14.7	(May) 3.7	(May) 8.2	(May) −0.9	(June) 4.7
Velocity of money (M1)*	(June) −0.4	(March) 5.5	(March) −5.3	(Dec.) 0**	(March) 3.1	(March) 0**	n. a.	(June) −1.4
Reserves minus gold *($ million, change from previous month)*	(Aug.) 0	(Aug.) 600	(Aug.) 55	(Aug.) −1,494	(Aug.) −443	(Aug.) 871	(Aug.) 212	(Aug.) 1,199

* Percent change from 12 months earlier.

**based on GDP

† Figures are only for the month indicated.

Reflation—And a Strong Dollar Ahead?

While economists and government policymakers worry about the current world recession and about the effects of the disinflation process on the international financial system, the stage may be being set for another round of worldwide inflation. Turmoil in the financial markets and the severity of the recession have already given rise to strong pressures for a move to inflationary economic policies in many parts of the world. It is possible that the engine of inflation is already being started. So far, the Federal Reserve seems to have resisted such a shift, despite its recent decision to ignore a rise in its "M1" measure of the money supply above target. And unless it becomes apparent that the Fed has changed course, the dollar will remain strong.

Pressures for a policy shift

Political pressures for the world's central bankers to reflate are clearly intensifying. Basically, they stem from two sources. The severity of the world recession is the major influence. Unemployment is now at 7.5% in West Germany, 8.9% in France, 10.1% in the United States, 11.1% in Belgium, 12.8% in the Netherlands, and 14% in Great Britain. Partly because of this, France has already chosen a reflationary path. And German unemployment—the highest suffered in 30 years—has been repeatedly cited as one of the principal forces underlying the recent fall of Helmut Schmidt's government. Another source of pressure for reflation policies is the fragile state of the world's credit markets. The recession has increased the risks of a severe crisis—admittedly only from "impossible" to "almost impossible." But the difference is significant, as it should be, to the world's central bankers.

The international financial system must now deal with the dangers of both corporate and sovereign default. Many recent corporate investments, which were made in the expectation of continued inflation, are no longer profitable. For example, in 1980, the per-barrel price of oil was widely expected to rise to $55 by late 1984. Drilling and exploration firms, among others, made their planning and investment decisions based on this projection. Today, however, many of the same forecasters are suggesting that $25-per-barrel oil is more likely. Consequently, now that anticipations have changed, investments made under the old expectations must be *repriced*. And this process will inevitably push some firms into bankruptcy. Although oil provides a clear example of how the disinflationary process leads to capital repricing, the same analysis applies to other commodities and capital expenditures made for mines, farm equipment, land, and other purposes.

Also worrisome is the increasing inability of some countries to pay their debts. This has been fostered not only by the world recession and high interest rates, but also by the same repricing problems facing many corporations. High interest rates imply greater strain on the export sector to finance higher interest payments at exactly the same time export demand has fallen. Normally, this would not be a problem, but with many countries' assets being repriced downward, new credit to cover deficits is less available.

Central banks fear that international bank lending, both to corporations and to countries, will contract sharply, possibly owing either to the bankruptcy of a major firm or to default by a large sovereign borrower. The result could be the onset of another and more severe worldwide recession. So the stakes are clearly high, even though the odds of such a sharp loss are still quite low.

The chances of a financial collapse are slight, but these chances are substantial enough that the monetary authorities of the major industrial powers are beginning to take action. They may even over-react. Certainly, one available policy choice—although one that many economists view as incorrect—is to inject massive amounts of liquidity into the world's economic system. This course would simultaneously ameliorate the symptoms of world recession and make it easier for borrowers to meet their obligations, both by easing access to new credit and by generating an inflation that would permit old debts to be paid with depreciating currency.

The impact on the dollar

Theoretically, a world reflation should be neutral for the dollar. However, the U.S. authorities have indicated that the United States may not fully cooperate in a world reflationary scheme. For instance, the American representatives at the September meeting of the International Monetary Fund in Toronto were conspicuously less sympathetic to the plight of the world's borrowers, arguing for much smaller increases in IMF loan quotas than the doubling proposed by some. The United States—or at least the current administration—is philosophically opposed to such rescue operations and more steadfast in its commitment to moderation in the creation of liquidity. And there are also economic reasons to think the United States will find it even easier to maintain a relatively tighter monetary posture in the long run if other industrialized countries now choose to loosen. Those reasons follow from the interrelatedness of the world's monetary regimes.

The dollar is still the world's key currency, but the current restrictive world monetary environment is not the product of Federal Reserve policies alone. It has resulted instead from a sharp fall in the rate of increase

Reflation—And a Strong Dollar Ahead?

(continued from page 7)

of the *total* world money supply. While the world money supply is not well-defined, it must include not only dollars, but also West German marks, Japanese yen, and other currencies that are becoming increasingly substitutable in world trade.

As is well known, the availability of substitutes is one important determinant of the demand for any commodity. Money is indeed a commodity, so the availability of foreign monetary substitutes must be regarded as one element determining the demand for dollars. Thus, when domestic and foreign currencies are substitutes, the monetary environment, and therefore economic activity at home, depend in part on the posture of foreign monetary authorities. This is clearly important for small, open economies. But it has recently been shown in the economics literature that changes in velocity—or the rate of turnover of money—in the large, industrialized economies are also associated with changes in foreign money supplies. And it has even been shown that inflation in the United States is better explained by changes in the world money supply, defined as a weighted average of dollars, marks, and yen, than it is by changes in U.S. dollars alone.

U.S. interest rates

Foreign monetary looseness will therefore make tight money a little less confining in the United States. Not only will foreign money serve to increase U.S. economic activity through increased export demand as the foreign economies recover, but foreign relaxation may now provide the impetus for the next fall in U.S. short-term interest rates. This could happen in the following way:

The short-term rate depends on the properties of money and interest-bearing financial instruments. Non-interest-bearing dollars are held instead of interest-earning liquid assets, such as Treasury bills or certificates of deposit, because of the transactions services non-interest-bearing money provides. The benefit of holding money is the transactions services it provides above those provided by "near-monies." The cost of holding money is the nominal interest forgone by not holding interest-bearing assets instead. In the short run—that is, when nominal income can be considered fixed—the short-term interest rate is the relevant price that equates the demand for narrowly defined money with its supply.

The production of more foreign balances in real terms—dollar-real-balance substitutes—reduces the marginal productivity of dollar balances. This means that even if the Federal Reserve maintains its current dollar supply strategy while foreign central banks loosen, the U.S. economy could enjoy lower interest rates with the same relatively tight U.S. monetary policy. Simultaneously in the bond and equity markets the process of adjustment will entail an incipient relative increase in the demand for U.S. dollar-denominated assets. The exchange markets adjust to the new policies as individuals bid up the value of the dollar, just as they bid up the value of dollar-denominated financial assets. Higher exchange rates work back into the U.S. goods markets, bringing lower inflation as greater competition from imports dampens price increases of American-made goods.

As apprehension about the possibility of world reflation grows, the financial markets will respond quickly. In fact, concern about an asymmetric world reflation may explain the current "unexplicable" strength of the dollar.

This theoretical presumption receives some support from world monetary data. The table below compares near-term and longer-run rates of M1 growth for seven major European countries and the United States. The table points to a coordinated pickup in the rate of money growth in all those countries where it was not already high. Although recent Fed actions support the view that the United States is in the pact, it is not yet clear if the Fed has changed its basic anti-inflationary policy. America is in a position to stop the money creation process. And as the table shows, despite the rapid money growth in the United States during the last two months, the U.S. money trend has decelerated in marked contrast to most of Europe.

Changes in M1
(percentage change*)

	Short-term**	12-Month
Belgium	19.4	4.5
France	14.2	14.3
West Germany	7.3	3.2
The Netherlands	37.1	6.2
Switzerland	16.3	3.5
Italy	14.5	7.5
Great Britain	14.3	14.4
United States	3.6	6.8

*period-over-period
**latest available 3-month average, annual rate

The table may contain the first portents of the next world inflation, an inflation fueled by central bankers' fears of recession and financial collapse. The Federal Reserve may be persuaded to participate, but, at present, it appears that the United States is the most likely of the Western nations to resist the temptation to print money excessively. If this is the case, then the United States might find itself as the possessor of the world's strongest currency, and an isolated island of price stability as the rest of the world becomes more and more dependent on inflationary finance.

Lee R. Thomas
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